

**The Islamic Wealth Management Industry (IWMI):  
Is the Current Financial Crisis A Blessing In Disguise?**

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## **Presentation Outline**

- Islamic Finance and the Financial Crisis
- Current State of IWMI (Magnitude and Performance)
- Current Islamic asset classes
- Investment Objectives not currently addressed by IWMI, and appropriate mutual funds
- SWOT Analysis
- Recommendations

## Islamic Finance Immune to the Crisis

- France plans regulatory and legal adjustments, to attract Islamic finance business
- French Finance Minister Lagarde “**Islamic finance is calling out to us**”
- The **Vatican** recommended adopting the principles of Islamic finance to “**ease the dangers of excessive credit generation.**”
- Prof. Rodney **Wilson: no Islamic bank has failed in the crisis**

## Crisis has Slowed-Down Islamic Finance

- “Credit crunch has impacted asset prices,
  - → not a good crisis for Islamic banks.
- “Islamic finance is based on the sharing of risk between institution and depositor
  - → clients will see what exposure to risk really means”.
- “Crisis led to **freezing** of overly innovative structures,
  - → delays in Islamic derivatives and hedge funds”.

## **Current State of IWMI**

### **Main drivers for Shariah-compliant financial product innovation and growth:**

- Surge of oil prices
- Rising Muslim wealth & financial sophistication
- Increasing interest in investing according to Shariah

## IWMI's Magnitude

- Islamic finance about **1%** of global market;
- could reach **\$4 trillion** in **5 years**.
- **20%** of Muslims in Asia and GCC “**would opt for Islamic financial products if given the opportunity**”.
- Shariah-compliant **investments** worldwide are **between \$1 trillion and \$1.5trillion**
- Shariah-sensitive investable assets in GCC and Asia were about **(2008: \$736b) up from (2007: \$267b)**
- → a potential annual revenue pool of **\$3.86b** for IWMI

## IWMI's Growth Potential

- “the market has witnessed
  - **enormous demand, yet almost no supply**”.
- Tareq Al-Rifai Director of Dow Jones Islamic Indexes
  - “ *the Islamic investing business in general, and **indexing** in particular, are **both so relatively new***
  - *only a small fraction of the Muslim public is even aware of its existence (and opportunity)*”
- % of households in the Middle East who own stocks < USA figures
  - ***if the public is educated* → potential growth of Islamic funds’**

## Muslim investors

- *“The entire industry is competing for 10%-20% of the global Muslim population”*
- IWMI needs to take Islamic finance to the **masses**, by *looking at their profile and risk appetite*
- A *“client pull rather than product push”* strategy is needed.
- HNW investors fin. assets at least US\$1m; UHNW assets > \$30m,
- Both *“prefer Shariah compliant products, but it is not compulsory”*.
- *“the longer the global downturn continues the more appealing will Islamic financing become to HNW and UHNW Muslim investors”*.
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## Evidence of Non-Muslims' Interest In Islamic Investing

- “**67%** of new money now flowing into the sharia-compliant **Amana Funds** at Saturna Capital in **USA**, comes from **non-Muslims**”.
- “**European and Asian investors** are buying into **Middle East Islamic bonds** in a bid to diversify their portfolios
- **Japanese investors** are intrigued by **Malaysian Islamic investments**
- “half of HSBC's Islamic mortgages in Malaysia went to non-Muslims the first year the company offered them”.

# Current IWMI Asset Classes

- **Conventional funds' 3 asset classes:**
  - cash equivalents, bonds, and stocks.
- **Islamic funds' asset classes** include Islamic products such as: Murabahah, Mudarabah, Ijara and and Sukuks.
- There are 2 types of Islamic products,
  - ***“A-Z Shari'ah-compliant structured products”***
    - both the structure and underlying asset are shariah-compliant,
    - favored by Islamic banks
    -
  - ***“Islamic bridge products”***
    - ***“a Shari'ah- compliant structure exposes investors to economics of non-Shari'ah underlying assets.”***
    - specialty of Western banks,
    - criticized by shariah scholars,
    - their use on the rise.

## **Building Blocks of IWMI**

- Deposit Accounts
- Mudarabah or a Wakala accounts
- Money Market Accounts
- Sukuks
- Commodity Murabaha Transactions
- Ijara Certificates
- Private Equity
- Venture Capital
- Derivatives

# Islamic Fund Choices

- **E&Y (2009) prediction:**
  - The Shariah-compliant funds industry can “*catalyze the next phase of growth*” **in the Islamic banking industry**
- Over 300 different companies currently manage Islamic mutual funds.
- **Shariah indexes →**
  - Shariah-compliant investing **more affordable** for the public
- # of Shariah-compliant funds grew by **22.7% CAGR** over the period **2003-October 2008**.
- **Financial crisis →**
  - fewer new funds were launched in 2008 compared to 2007,
  - a noticeable decline of new IWMI entrants.

## Mutual Fund Category Distribution

	<b>Conventional Funds</b> , source: (E& Y 2009)	<b>Islamic Funds</b> source: (E& Y 2009)	<b>Islamic Funds</b> source: Eurekaledge, cited by McNamara (2009)	<b>Islamic Funds</b> source: Reuters, cited by Siddiqui (2009)
<b>Assets under mgt</b>	N/R	N/R	<b>\$45-\$50 billion</b>	<b>\$25 billion</b>
<b>Number of funds Worldwide</b>	<b>61,000</b>	N/R	<b>679 funds as of Q2, 2009</b>	<b>561 funds as of Q2, 2009</b>
<b>Fund Category Distribution</b>				
<b>Equity</b>	<b>42%</b>	<b>52%</b>	<b>52 %</b>	<b>55%</b>
<b>Fixed Income</b>	<b>22%</b>	<b>7%</b>	<b>6%</b>	<b>11%</b>
<b>Balanced</b>	<b>20%</b>	<b>10%</b>	<b>8%</b>	<b>N/R</b>
<b>Money Market</b>	<b>6%</b>	<b>13%</b>	<b>13%</b>	<b>13%</b>
<b>private equity</b>	N/R	N/R	<b>18% PE and real estate combined</b>	N/R
<b>real estate</b>	N/R	N/R		<b>3%</b>
<b>Mixed</b>	N/R	N/R	N/R	<b>17%</b>
<b>other</b>	<b>10%</b>	<b>18%</b>	<b>4%</b>	<b>3%</b>

**Table (1) Mutual Fund Category Distribution**  
(N/R)=Not reported

## Performance of Islamic versus conventional Indices

<b>Index Performance</b>	<b>Global BMI</b>	<b>USA500 5 yr</b>	<b>Europe 350 5 yr</b>	<b>Japan500 5 yr</b>	<b>GCC Composite 2yr</b>
<b>S&amp;P Shariah</b>	<b>-28.52%</b>	<b>1.07%</b>	<b>5.67%</b>	<b>-2.49%</b>	<b>-16.08%</b>
<b>S&amp;P</b>	<b>-28.67%</b>	<b>-2.24%</b>	<b>2.97%</b>	<b>-2.86%</b>	<b>-14.86%</b>

**Table (3) Performance of S&P Conventional and Shariah Indexes in Various Countries as of June 30, 2009**

**Source:** S&P (2009c) “Shariah Report July 2 0 0 9”

## Performance of IWMI During The Financial Crisis

- Past five years
  - the DJIMI has declined 4%, outperforming
  - the conventional Dow Jones World Stock Index declined 8%
- The S&P Shariah indexes for USA, Europe, and Japan have outperformed their conventional counterparts for the 5 years ending June 30, 2009
- **“Shariah investing has delivered a good track record in difficult times with out performance and lower volatility”.**
- **inverse correlation with financial stocks → IWMI might fall behind** once the financial sector’s recovery begins.

## Current Islamic Funds Situation

- Most funds
  - invest in equities and focus on **growth and capital protection**.
- **Asset allocation** does not suit the **risk/reward** profile of the **average Muslim** investor who **typically**
  - does **not** have \$10,000 minimum initial investment
  - prefers **stability of principal** or **current income** objectives
- **IWMI needs to consider Investors' differences** in terms of
  - goals, time-horizon, degree of risk tolerance, constraints, and liquidity requirements

## **Stability of Principal (SOP) Objective**

- **the most conservative objective → the lowest return**
- **The SOP client**
  - prefers no chance of principal decline
  - has a limited amount of capital or is
  - less educated about investing.
- **Investment Vehicles include**
  - **Murabahah Funds:**
  - **Principal Protected Funds**
    - most (attractive and expensive) during volatile market cycles.

## Income Objective

- **requires taking more risk and generates a higher income than SOP**
- Income client is typically
  - **retired and tolerates a periodic principal decline.**
- Investment vehicles include:
  - Sukuk Funds
  - Ijara Funds
  - Currency Funds
  - Commodity Trading Funds,
  - Equity Income Funds: dividend-paying large stocks.

## **Growth Of Income Objective (GOI)**

- The GOI client **sacrifices some current return for some protection against inflation.**
- Investment vehicles include:
  - **Mudarabah Funds,**
  - **Real Estate Funds:**
  - **Balanced Funds**
  - **Value Funds: P/E < industry average.**
  - **Index mutual funds,** mirror an index such as DJIM

# Capital Appreciation Objective (CA)

- **Most aggressive objective** → highest return and lowest income.
- **CA client** is typically
  - young, wealthy, has a high tax bracket,
  - is interested in growth, and
  - does not need current income.
- **Investment vehicles include:**
  - Growth funds
  - Small-Cap funds
  - Mid-Cap Funds
  - Sector Funds
  - International funds.
  - Islamic Hedge Funds.
  - Exchange-Traded Funds (ETF's)
  - Private Equity funds

## SWOT Analysis of IWMI: Strengths

- **Conservative practices :**
  - IFI's are moderate investors.
- **Risk Sharing**
  - represents an investor's safety net.
- **Valuable Screening Criteria**
  - Screening helps in **avoiding bad stocks**,
  - Serves as a "*valuable analytical tool*" .
- **High Growth Potential**
  - *"people are buying this product for a very simple reason - the Middle East is going up"*.

## Weaknesses of IWMI

- **Reservations about Islamic Finance Industry Practices**
  - “*Islamic financial system has **not come out of the straitjacket of conventional finance***”
  - “*Islamic financial products as **Shari’ah-compliant caricatures of conventional offerings***”.
  - **Humayon Dar: 75% of Muslims**
    - “***reject Islamic banking and finance*** , it does not offer any real economic value, different from conventional products”.

## Weaknesses of IWMI

- **Diverse Regulatory Requirements**
- **A Fragmented Industry ,**
  - **divergent views →**
    - “ *it's difficult to set up a geographically diversified Islamic fund*”.
  - **More than 50% of Islamic funds have \$20m or less in AUM,**
  - **67% have <\$100m AUM →**
    - higher expense ratios,
    - an inability to benefit from economies of scale.

## Weaknesses of IWMI

### Fund Construction and Management

- **Limited Availability of Islamic products in some countries**
- **No Generally Accepted Investment/Screening Guidelines**
  - Screening dissimilarities lead to "*insecurity and distrust of Islamic investors into financial products like funds*" and
  - may hinder IWMI's growth.
- **Disputed Income Purification Standards**
- **High Set-Up Costs**
- **High Research Costs**

## Weaknesses of IWMI

### Sales and Marketing

- **Narrow Product Offerings**

- → Muslim investors resort to “***products that replicate the performance of conventional assets in a Shariah-compliant way***”.
- IWMI needs diversity “***both in terms of management style as well as in underlying assets***”.

- **Short Track-Record**

- difficult to compare **relative performance** with conventional funds.

## Weaknesses of IWMI

- **Human capital**
  - **Shariah Scholars' Shortage**
  - **Professional Managers' Shortage**
    - best managers are mostly from the conventional sector.
- **Distribution delays**
  - *“the local Islamic banks **re-approve** every product they distribute”*
- **Misconceptions about IWMI**
  - *“Islamic investments products still perceived to be **fairly niche & not totally understood**”*

# Weaknesses of IWMI

## Risk Exposures

- **Shariah Risk**
  - “ *the risk that the product you thought was shari'a-compliant may turn out not to be*”.
- **Reputational Risk**
  - reputation-damage if there are doubts about the products' shariah-compliance.
- **Suspicious of Links to Terrorism**
- **Scholar's Non-Consensus Risk**
- **Exposure to Volatile Real Assets (oil, real estate, commodities)**
- **Weak Risk Management Tools**

# Opportunities

- **Increasing Scrutiny by AAOIFI of Islamic Products and Services.**
- **Re-Evaluation Breather**
  - *Crisis → Scholars reassess the sharia-compliance of some of the products that emerged in the boom years”.*
- **Major Cities’ Interest in Islamic Finance**
- **Rising Interest In Professional Management** (due to Recent Stock market volatility)
- **Less Restrictive Regulatory Framework** (foreign investments allowed in)
- **Portfolio Diversification Benefits** (for Western investors, low correlation with West)
- **Untapped Muslim-Investor Demand *in the West and Muslim countries***
- **Rising Interest from Socially Responsible Investors**

## Threats to IWMI

- Inactive Secondary Markets
- Increased Competition
- Double Taxation
- Uncertain Regulatory Environment

# Recommendations

- **Establishing a Global Regulatory Body**
- **Improving Governance**
- **Innovation Leadership by IFI's not the West!**
- **Enhancing Secondary Market Liquidity**
  - distribution of Islamic Sukuk funds,
    - → smaller retail investors invest in Sukuks
      - → better liquidity
- **Product Standardization (Controversial!)**
  - reduce transaction costs and
  - lower entry barriers for international players
    - → Increasing competition
    - → benefit of customer

## **Recommendations**

- **Educating the Public**
- **Marrying Shariah and Corporate Social Responsibility (CSR)**
- **Diversifying Product Offerings**
- **Improving Marketing/Distribution**
- **Targeting New Investor Segments**
- **Standardizing Screening Criteria**

## Conclusion

**Professor Mehmet Asutay** calls for taking an inward look at **Islamic finance's ethicality**

- *“there is little indication that the industry is entirely ethical...*
- *Their perceptions of CSR remain within the framework of **zakat distribution** and other non-systemic **charitable activities** rather than*
- ***working towards capacity building for developing communities”**.*

- Questions?