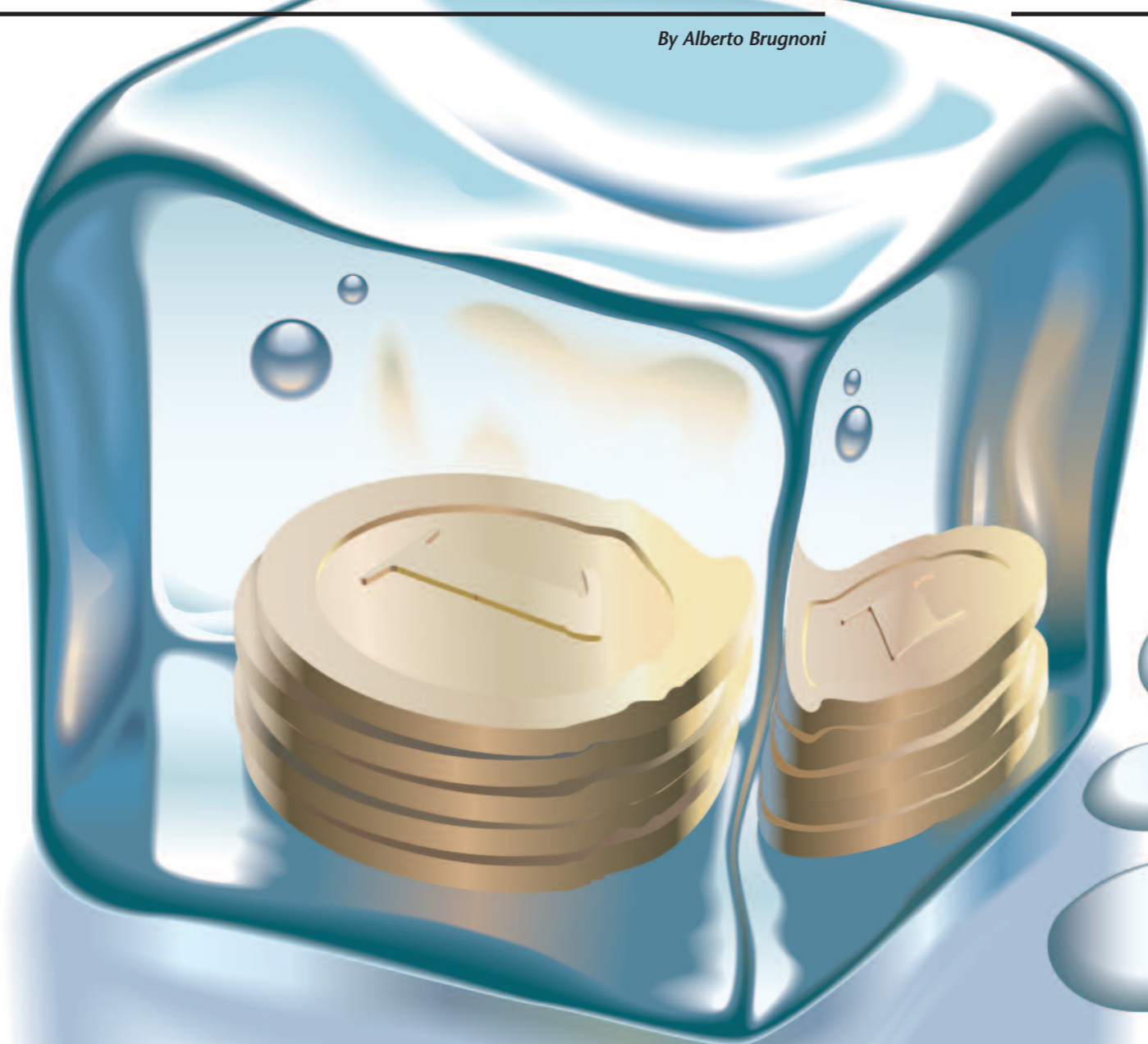


Global Phenomenon Regional Focus

By Alberto Brugnoli



The 3rd Annual Failaka Islamic Fund Awards, held in Dubai earlier this year, once again drew attention to the exciting growth of Shariah-compliant investment funds worldwide by gathering the world's top-performing Islamic investment funds.

This year, the Failaka Awards spotlighted consistent, long-term returns by adding categories for best three-year and five-year performance and, for the first time, featured two informative sessions: one on “Regional Trends” (GCC, Europe and East Asia) and another on “New Developments in Islamic Fund Management” (ETFs, new index strategies and hedge funds). This new format offered attendees a unique opportunity to evaluate the present state of the industry and to hold a lively formal and informal debate. Some of the issues discussed include:

The Islamic Mutual Funds Industry Today

While the equity Shariah-compliant funds adventure began in the ‘80s when the most prominent Islamic intermediaries started to widen the coverage of financial instruments to serve the financial needs of HNWI, the industry lagged for a number of years. The Shariah-compliant collective investment schemes really took off only in the second part of the 1990s and they have now experienced dramatic growth. In 2007, they reached more than 320 funds with total assets under management of around \$33 billion. These assets are being managed by investment houses based in the GCC as well as by many primary Western investment houses. Their most common structure is still based on mudarabah, the well-known profit-and-loss-sharing contract in which no fixed return can be agreed.

The Shariah-compliant funds industry showed solid performance in 2007 — notwithstanding, or perhaps thanks to, the stream of negative financial news. The DJIM World Index recorded a gain of 17 percent for the year, while the DJIM US gained almost 15 percent and the DJIM Europe more than 18 percent. On the regional level, emerging markets performed very well: Asian markets, particularly in

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Malaysia, along with certain South American markets, have been stellar performers in 2007. Of the 10 top-performing funds, seven were BRIC or Asian-focused, the other three being GCC/MENA-centered. In the GCC, markets continued their modest upward trend, although those in Saudi Arabia and the UAE were relatively flat while the Kuwaiti market posted important gains.

With regard to the 2008 investment outlook, the point was made that macroeconomic factors are most favorable. The global meltdown, economic slowdown, low interest rates and negative real interest rate environment, record high oil prices, record high government spending and mega infrastructure and real estate projects should benefit most listed companies and translate into growth for their corporate earnings and share prices alike. The GCC project pipeline for the next five to seven years of around \$1,554 billion should be seen as a powerful catalyst. Other factors, such as the current P/E ratio and the very low correlation of GCC equity market with the S&P 500, point to the same direction.

Islamic Mutual Funds Investment Process

With regard to the investment process, the discussion focused on how Shariah proscriptions should govern the new challenging and rapidly changing financial environment in the following three distinct phases:

Portfolio Asset Allocation

The starting menu of stocks is to be screened according to the religious proscriptions that follow qualitative and quantitative criteria. The former relates to the main activity of the company and to the way in which the company is financed or invests its liquid assets. The latter relates to debt, interest-bearing securities and receivables and cash. While the shared opinion amongst the scholars, based on hadiths, is that the total outstanding debt must not exceed one-third of the capital and the same rule applies to cash and interest-bearing securities of the assets, the deliberations of Shariah scholars should take into account the new forms of financing that come to the market.

Instruments and Trading Strategies

Since there is no clear Shariah guidance as to their acceptability, it is necessary to identify the

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issues that arise using “traditional” instruments such as shares, bonds, futures, options and swaps as well as the new instruments. This is now becoming of the utmost importance because new asset classes that apply innovative techniques — such as hedge funds, funds of hedge funds, absolute return funds, private equity, REITs, structured products, quantitative products and ETF — will continue to squeeze the traditional core of actively managed funds.

An example is bonds: their certificate is evidence itself of a lender-creditor relationship that violates the general prohibition of riba, but now it is possible to overcome this issue, as some innovative structures have been developed to allow greater freedom for investors. With regard to stocks, the common class is approved as an instrument for investment if the company's business is Shariah-legitimate, while the same does not apply to the preferred class, because it guarantees the amount of the dividend and this is tantamount to riba. This also deserves a fresh look on the part of Shariah scholars. Short selling and margin trading are severely restricted, but here again, innovation is rife and should be accounted for. Some important additional considerations are related to derivatives such as stock futures and options.

Income Distribution and Purification

Balance figures that are riba-contaminated are to be cleansed or purified. This purification process is done either by the fund manager before any distribution of income, or by reporting the necessary financial ratios for investors to purify their earnings on their own. The new dividend purification tools available in most indexes deserve a fresh look as well.

As investor confidence, education, and personal incomes converge, a sustained push in global equity and Shariah investment should continue to take shape. It is also likely that institutional flows will continue to grow as money managers develop longer track records and new Shariah-compliant strategies and continue to build trusted relationships.