Islamic asset management: myth or reality?

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A back-water of Shari'ah finance for a long while, can asset management finally become mainstream? John A Sandwick, an Islamic asset management specialist based in Switzerland, explores this issue.

History of Islamic asset management

In the early days of the Islamic banking sector back in the 1980s, there was one big debate about whether zero-coupon corporate and government bonds were Shari'ah-compliant or not. The practitioners were understandably naïve then, as no one at that time had addressed some of the core issues surrounding the precise definition of Islamic banking.

Since then the industry has skyrocketed, in particular since 2002 and the modernisation of much of the banking sector in the Middle East. Just as conventional banks in the Arab world were upgrading and updating systems and procedures, so did the Islamic banks. Moreover, some key figures emerged to help standardise the process of at least thinking about basic rules and principles of Islamic banking. Among them were Mohamed El Gari, Humayon Dar and Mohamed Daud Bakar, to name only a few of the most notable pioneers. These Islamic scholars and specialists placed the first level surface on which banking professionals could begin developing products and services that met both Shari'ah and international banking standards.

However, very little of this innovative and ground-breaking work entered the Islamic asset management space. Rather, it was the retail, corporate and investment banking sectors that benefited from the professionalisation of Islamic finance industry. Asset management seemed to have been the poor stepchild, less exciting and less rewarding to the professionals than high-volume retail banking or highly compensated investment banking.

Now, however, there are the tools and knowledge to make Islamic asset management a reality. Whether institutional investing for pension funds, takaful (Islamic insurance) companies or corporate treasuries, or retail investing for households, the technology exists to professionally create, manage and distribute Islamic mutual funds and other assets on a wide scale.

All that's missing is banking institutions willing to follow the path. Strangely enough, the market has witnessed enormous demand, yet almost no supply. Conventional vs Islamic asset management

Conventional asset management combines the tremendous progress made since the 1950s in statistical evaluation of historic security pricing and the quantification of expected risk and reward. Many Nobel prizes were awarded to those who advanced our thinking on how to invest our savings, ensuring that we had a high probability of achieving both income and capital gain objectives in a rational, coherent fashion.

Modern Portfolio Theory, or MPT, first advanced by a distinguished American economist, Harry Markowitz, in his ground-breaking work in 1955, relies on our intuitive sense that we need moderation and diversification among our investments. In 1970s, James Tobin advanced this work by introducing the risk-free rate of return (wrongly criticised by some Islamic banking neophytes), and later William Sharpe gave us tools for more careful evaluation of assets through the Capital Asset Pricing Model (CAPM).

MPT is the bedrock of conventional asset management. It calls for diversification among asset classes – cash, fixed income, stocks and alternative investments – and diversification inside these asset classes. By fine-tuning the allocation over time one can reasonably expect MPT to help achieve one's investment goals.

There are very good critics, of course, such as a French mathematician, Benoît Mandelbrot, who is considered to be the father of fractal geometry, and a US scholar, Nassim Nicholas Taleb, the author of the Black Swan theory, but no matter how valid these critics may sound they still have not given us any practical substitute for MPT. Professional asset managers, in other words, must still allocate their clients' money according to the same rules and principles that have been with us now for almost 60 years.

Importantly, just as there is no specialised field of professional practice called 'Islamic dentistry', so too there is no real separate body of work called Islamic asset management. In other words, both conventional and Islamic asset management start and continue in nearly identical processes and share nearly all of the same methodologies.

When clients ask a major global asset management bank to manage their wealth using conventional asset management, they generally get very good service and performance. No asset manager at Deutsche Bank or Morgan Stanley would ever consider deviating from the universally accepted professional rules of asset management, or MPT. They would be fired if they placed client money into new or untested theories of investing.

The performance of conventional asset managers has been extensively studied for almost a generation in what is called attribution analysis, and the results are surprisingly homogenous among all the world's asset managers. Why? Because they all use the same methodologies to invest client funds, founded on MPT.

But when a client walks into a bank and asks for Shari'ah-compliant asset management there is either one of two responses. The first is an honest 'no, we don't offer that service here'. Truthfully, no institution anywhere outside of Malaysia can offer Islamic asset management today.

The second response is dishonest. Some of the most prestigious banks in the world claim they have Islamic asset management, but in reality, they use derivative-based structured products (with fatwa) combined in such a fashion as to achieve the objectives of MPT.

Islamic asset management: what to buy

In fact, over the last six years there has been a pell-mell rush into the sale of derivative-based structured products with a fatwa wrap. These products are by and large toxic waste, and the recent meltdown in global markets only magnified the underlying mistrust about their application in nearly all institutional and private client portfolios. Don't blame the Shari'ah scholars for these time bombs. They are hired only to say whether the investment violates the rules and norms of Islamic ethics. The responsibility for such wasteful investment schemes lays entirely on the shoulders of bankers. After all, structured products are not a substitute for MPT allocations. They never have been and never will be. Like Warren Buffet famously said, derivatives are weapons of financial mass destruction.

Yet, that didn't stop many western banks and equally Islamic banks operating in the Middle East from pushing hundreds of millions, if not billions, of dollars worth of these products onto unsuspecting clients. Islamic investors were coaxed into thinking they were getting a responsive product with fatwa, yet in fact were being peddled irresponsible trash that no professional would ever buy himself.

During the same period we saw an overwhelming consumption of regional and international private equity, including for real estate, by investors in Saudi Arabia and the Gulf region. Why did this occur? Firstly there was in fact a real need for professional venture capital to be introduced into the developing economies of the GCC. But what should have been the normal evolution of a new, high-risk investment industry became instead a stampede. From only two private equity houses in the Middle East at the beginning of the decade, we saw over 100 established by 2008.

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The abundance of so many private equity houses in the region, plus a big push from foreign banks to sell their own private equity deals, was too much for less sophisticated investors. They consumed them in vast amounts, in the process tilting the balance of MPT allocations far too deeply into risky, illiquid assets.

Now the chicken has come home to roost. Investors everywhere – and not just in the Arab states – indulged themselves in the fantasy that somehow private equity provided less risk and more reward than MPT. The cost is high. It hurt the biggest investors the most, where private equity cash calls dried up liquidity. Now we have seen that an overly amorous approach to this dangerous zone of the investment universe is best taken in extreme moderation. It may be another generation before we see the kind of over-investment in private equity that occurred during the last five or six years. The great shame of today's so-called Islamic asset management industry is that there really is no such industry. Many claims being made about the applicability of most Islamic products are generally false. No single major bank or investment company has delivered a credible line-up of professionally developed products that also meet the standards of Shari'ah. Perhaps greed, perhaps inertia, and perhaps ignorance are reasons for this unhealthy situation. Certainly it is not a lack of resources. If major international and regional banks dedicated themselves to MPT with fatwa, the situation could change dramatically in short order.

How to invest today according to Shari'ah

A very few asset management professionals have taken a serious look at what constitutes Islamic asset management and Islamic wealth management. We have developed quantitative models that start with a deep scan of the available universe of Islamic products, and then combine them in a format that achieves the desired results required by MPT.

Many investors are seeking the golden egg, the one style of investing that is foolproof during all economic conditions. Unfortunately, no one has come up with that bird yet! There still remains more than abundant risk in the world, and avoiding risk occupies as much time of a professional asset manager as actually seeking profits.

However, it can be stated unequivocally here that Islamic asset management is no different than conventional asset management when it comes to constructing a portfolio that will have a high probability of achieving an investor's goals. To do that an investor seeking professional investments with competent fatwa does not need to sacrifice anything: not performance, not transparency, and not pricing.

The process starts by choosing an asset manager who understands Shari'ah. For many bankers, the entire concept of socially conscious investing is perfectly acceptable, but the idea of Shari'ah-compliant investing is strange and exotic. It isn't. Shari'ah is not rocket science, understood only by a rare qualified few. It is the guiding principles of a faith with over a billion adherents. Surely such a popular and common religion doesn't exist based on mysteries and secrets. The moral precepts of Shari'ah are abundantly clear to anyone who wishes to pick up a copy of the Holy Quran. Bankers unfamiliar with Islam will find nothing alien in Shari'ah, in particular when it comes to Shari'ah compliance of investment products.

The community of generally accepted Shari'ah scholars makes it easier for the novice investment manager to achieve a balanced, professional portfolio allocation. By choosing assets that have been granted a fatwa by that group of Shari'ah specialists who closely follow financial markets, any investor or asset manager can start the process to assemble a portfolio allocation that meets both Shari'ah and MPT standards.

All that said, we are living in dangerous times. One major investment company chairman declared earlier this year that nearly 40 per cent of worldwide wealth had been destroyed by the global credit crisis. Clearly we have to be careful.

Being careful means diversifying your assets. It means not overloading on any single asset class, but instead insuring that your portfolio is carefully constructed with certain amounts of cash, fixed income, stocks and alternative investments. A typical allocation today for a non-Muslim investor might be five per cent in money market investments (cash), 45 per cent in a diversified mix of bond funds (fixed income), 35 per cent in a globally diversified allocation of stock funds, and 15 per cent in a mix of real estate funds, hedge funds, commodity funds and other alternative investments (but no structured products, please!). This provides no guarantee of outstanding performance in the short run, but it does guarantee that your savings are protected from the worst of the swings we've seen in the world today.

A Muslim investor who wants to achieve the same objectives can do so, as long as he seeks the aid of a dedicated professional who understands both Shari'ah compliance and MPT. Proper security selection can now be made at every level of the allocation spectrum, from cash to fixed income to stocks to alternative investments, all with respectable fatwa from notable Shari'ah scholars. While presently there is a dearth of professional managers in Islamic asset management sector, with the high demand this trend is likely to change.

At the end, we start at the beginning

Islamic banking has like other areas of professional practice witnessed some very creative, innovative expressions of human ingenuity. From nothing we have seen the development of world-class Islamic retail, corporate and investment banking in little more than a generation. But, this didn't yet extend to Islamic asset management.

Hopefully, over the next few months and years, new Islamic investment products will be introduced to the market. MPT has given asset managers a path to responsibly invest their clients' savings, and if they want those investments to also carry fatwa then we owe it to them to deliver. Now that we've seen Islamic asset management can become a reality, it's time to deliver the products and services people want.

Islamic asset management & Islamic wealth management

Some readers may be confused by the often interchangeable use of Islamic wealth and Islamic asset management. Conventionally, there is a difference. Wealth management often refers to professionally managing the wealth of an individual or a family. Asset management means investing for an institutional client, such as a pension fund or waqf, or a bank's treasury department. However, whatever the name there is no essential difference between the two. Professional asset management involves the same rules, processes and results whether for individual or institutional savers. This equally applies to Islamic wealth and asset management.