Islamic Asset Management — Asia vs Arabia

By John A. Sandwick

In Islamic asset management over the last decade there appears to have been a major missed opportunity in Saudi Arabia and the Gulf region, what I call Arabia, versus progress made in Malaysia. Private equity was the primary culprit for an unprecedented distortion of capital flows in Arabia, mostly for real estate but also for corporate investments. For the first time in modern history private equity trumped mutual funds. This was not the case in Malaysia, which continued to pursue normal, balanced growth in mutual funds throughout the decade, leaving private equity to its normal niche status.

Since 2001 we saw enormous gains made worldwide in the Islamic banking industry generally. While many declare that Islamic banking was born in 1975 or even earlier, it is clear that these are just figurative milestones. Real progress in developing workable solutions in Islamic retail, commercial and investment banking was only made in the past decade.

Progress in mainstream banking was relatively even in the world's two major spheres of Islamic banking — Malaysia and Arabia. For example, both spheres produced attractive, meaningful retail banking services and products. Auto loans, credit cards, overdraft credit lines and other products typical of consumer banking all have been ensconced in credible Shariah compliant packages.

Neither Malaysia nor Arabia can claim leadership in this area, as both were developed simultaneously, if somewhat autonomously. The same can be said for investment banking (Sukuk, convertible Sukuk and mergers and acquisitions or M&A, for example) as well as corporate banking (export credits, import credits and term credits, as examples).

The sector of banking with the most glaring disparity, however, was in the subset of activity called asset management. Here, the Malaysians far outstripped and outpaced their Arabian counterparts in developing credible products and efficient markets.

Unit Trusts	Subscribers	Population Penetration Rate	AUM to GDP
Malaysian conventional	12,375,369	46.0%	27.0%
Malaysian Islamic	1,781,505	6.6%	3.4%
Saudi Arabia*	371,000	1.5%	16.0%
US	92,000,000	30.0%	68.0%

**Conventional & Islamic, although the large majority of funds are Shariah compliant*

The numbers don't tell the most compelling story. One must look a little deeper to come up with the conclusions. Asset management comprises the professional management of savings owned by savers of capital. It includes treasury management at banks and Takaful companies, as well as private banking, where one manages the savings of families and individuals. It also includes retail and institutional distribution of mutual funds.

Professional asset managers assigned to make investments on behalf of contracted clients are usually constrained by what we call the "prudent man" rule. Prudent man exists nearly everywhere, a common feature of the regulatory environment in almost all countries. Prudent man means a professional asset manager cannot make an investment for a client that he would not make for himself, considering all aspects of the client's risk and reward profile.

Underlying asset management, of course, is the Modern Portfolio Theory, which says one must allocate a client's assets in a fashion that achieves diversification across asset type, industry and geographic boundaries. A prudent man, therefore, would take his client's money and invest it in a broad array of securities that are widely diversified, from the safest to the most risky investments. A portfolio's composition would reflect the client's investment objectives: a younger client would naturally prefer higher risk and higher return, while an older client the opposite.

By extension, of course, even the wealthiest of family offices or private investors should themselves follow the prudent man rule. It is a universal concept, not just applying to professional asset managers but to anyone making investments.

After diversification the second cardinal rule of asset management, and a major component of the prudent man rule, is liquidity. Common among all applications of asset management — whether for individual or institutional investors — is the ability to sell an asset when needed. In no area of asset management does one commonly find illiquid, long-term investments except as niche products, comprising a small minority of total investments.

Applying the Modern Portfolio Theory and the prudent man rules gives us allocations that are generally highly or mostly liquid. That means the smallest portion, if any, of a client's assets would be used to purchase securities that could not be converted into cash on short notice, from overnight to one week to at most three months. Anything with redemption rights longer than three months can only be classified as illiquid, and therefore one of the many forms of private equity.

Liquidity is a common feature in the mutual fund industry. Looking at any major family of mutual funds — whether from BlackRock, UBS, Prudential, Credit Suisse, Citibank, Fidelity, Franklin Templeton, CIMB or Saudi Fransi Bank — one sees that the vast majority or all of the investment products on offer are liquid, meaning short-term redemption periods are generally available.

This is where the Malaysian and Arabian asset management industries differ widely. Malaysia, home to one of the world's most vibrant Islamic mutual funds industries, has 153 mutual funds distributed across over 1.78 million customers, from individuals to institutions.

As there is about US$6.63 billion under management among the 153 Islamic mutual funds in Malaysia, and an underlying population base of 26.9 million, one can conclude that Islamic mutual funds in Malaysia have achieved a comparatively high penetration rate.

Arabia, too, has a relatively large and important mutual funds industry. There are about 140 Islamic mutual funds among the six countries comprising the Gulf Cooperation Council region. But the penetration rate is very low. The ratio of assets under management (AUM) to total

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population is much lower than in Malaysia, and becomes even lower when one removes the expatriate populations of this region.

There are some stark examples of the differences. Malaysia was home to the world's first true Sukuk funds, long before they were even considered in Arabia. Considering that the Modern Portfolio Theory led global asset allocation today to reach somewhere around 50% of all managed assets in fixed-income investments, one can easily see how critically important it is to have Sukuk funds for Islamic asset management. In contrast, in Arabia today there are only three Sukuk funds with barely US$70 million in AUM. Malaysia, on the other hand, has seven with nearly US$1 billion in AUM.

Region	Funds	Assets under management US$ (million)
Malaysia (conventional)	416	52,032
Malaysia (Islamic)	153	6,630
GCC (Islamic)*	140	19,355

**Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the UAE*

At the same time Islamic private equity firms in Arabia are estimated to have drawn in at least US$50 billion in private investor funds between late 2002 and mid 2007. This is a phenomenal amount considering that Islamic mutual funds themselves are also at about US$50 billion in AUM. In other words, Arabian investments in Islamic private equity were about equal to investments in Islamic mutual funds.

Nowhere in the world can one find such a disparity. Private equity globally equals only a couple percent of total AUM, at most. But in Arabia Islamic private equity constitutes fully half of AUM when measured against Islamic mutual funds.

Worse still, it appears that conventionally traded securities such as stocks and bonds — and their Islamic counterparts, which comprise Shariah compliant stocks and Sukuk — have largely made up for their losses from the great crash of 2008-2009, yet private equity positions have very likely worsened.

Most private equity deals sponsored by Gulf regional investment companies were suspected of being overpriced at their inception, and today face markets with few exit possibilities, the lifeblood of private equity. Conventional exit strategies are almost nonexistent: credit that was once abundant has dried up, IPO (initial public offering) volumes are down dramatically, and industry or trade sales are rare in a conservative, credit-starved climate.

It took a crisis of the proportions found in 2008-2009 to disclose the inherent weakness and very high risks of GCC regional private equity, a factor seemingly overlooked by investors during the boom years.

Clearly there was a distortion in the normal flow of Arabian capital between savers and users during much of the last decade. Whereas in Malaysia private equity remained a niche investment category, just as it was throughout most of the world, in Arabia private equity dominated, and by a very large margin.

Fortunately, capital flows have a self-correcting tendency. We know, for example, that certain asset classes become overbought and overpriced. Bubbles form, and bankers become complacent, thinking this is the new "normal." Then the bubbles burst, and the excesses become apparent, prices collapse, and firms go out of business. We can witness this right now with many of the private equity houses in Arabia, where many firms gorged themselves on large volumes of illiquid, long-term investments made on behalf of clients.

What is hoped for now is that Arabia's Islamic bankers will opt for a more traditional flow of capital, where Islamic mutual funds are the preferred destination for individual and institutional savings.

Instead of focusing so much energy on producing investment products that are inherently highly risky because of their long-term nature and illiquidity, perhaps now is the time for the introduction of families of plain vanilla Islamic mutual funds that all bear the hallmark of liquidity.

The love affair with private equity was not unique to Arabia. Private equity drew in enormous sums worldwide, reaching historic levels by 2007. But most of the major private equity houses in the conventional space concluded that their growth was funded by abundant, cheap credit and investors willing to lock away their money in high-risk, illiquid investments.

They are adapting new strategies in a credit-starved world, one with less appetite for the high-rolling, high-risk ventures of the last decade.

Times have changed. Because of massive losses from the financial crisis, investor sentiment toward illiquid investments in private equity is reaching new lows, and the industry's ability to attract savings has been severely handicapped. Now is the time for asset managers to change the game, offering products that may produce less fees, but meet public demands for savings in more traditional forms.

We may be finally entering the era where private equity is relegated to a niche investment class, and where plain vanilla Islamic mutual funds dominate the capture of new capital flows from savers, finally adjusting to world standards.

This paper was prepared with the assistance of Thom Polson, a graduate student in Islamic banking and finance at Bangor University, UK.

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