



## 2010 Key Trends in Islamic Funds

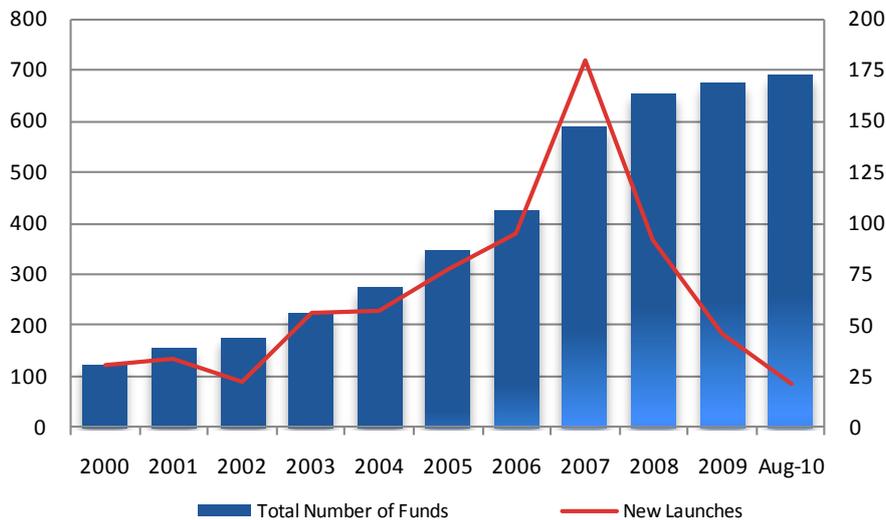
Eurekahedge  
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### Introduction

The rapid development of the Islamic fund industry over the last decade represents the progress and advances made in the Islamic finance sector. The primary goal of Islamic funds is to engage in 'ethical investing' into products and companies that are acceptable to the Islamic faith. As such, Islamic funds are wealth management vehicles that cater to investors who want exposure to capital markets inside a Shariah framework, which is the key distinguishing factor from other conventional funds.<sup>1</sup>

Currently, the total number of Shariah-compliant investment vehicles is estimated to be 690, with assets standing just over US\$72 billion. Figure 1 shows the growth in the total number of Islamic funds since 2000.

**Figure 1: Industry Growth over the Years**



Source: Eurekahedge

The Islamic fund sector experienced sustained growth in 2007, which saw the launch of 180 funds. However, subsequent years have seen a decline in launch activity though it should be noted that despite a slow growth rate, the number of funds did not decrease as Islamic funds mostly invest in asset-backed securities and do not apply leverage, hence, limiting performance-based losses. Additionally, existing funds have further consolidated their positions in 2009 and 2010 – the Eurekahedge Islamic Funds Index is up 32.17% since February 2009.

The new launches in 2009 and 2010, although comparatively small in number, represent increasing diversity in the industry in terms of asset classes and industry segments as well as geographies and investors. The sector has adjusted to the changed landscape post-financial crisis and has attracted attention from various quarters including western banks and investors. Sukuk issuances have picked up substantially, even from companies such as General Electric, while new Islamic funds have launched in places like Australia.<sup>2</sup>

The rest of this report gives a snapshot of the current industry make-up as well as the latest performance trends.

<sup>1</sup> For a more detailed description of what constitutes Islamic investing, please refer to the Eurekahedge Key Trends in Islamic Funds report published in January 2010.

[www.eurekahedge.com/news/10\\_jan\\_EH\\_IF\\_KeyTrends\\_Full\\_ABR.asp](http://www.eurekahedge.com/news/10_jan_EH_IF_KeyTrends_Full_ABR.asp)

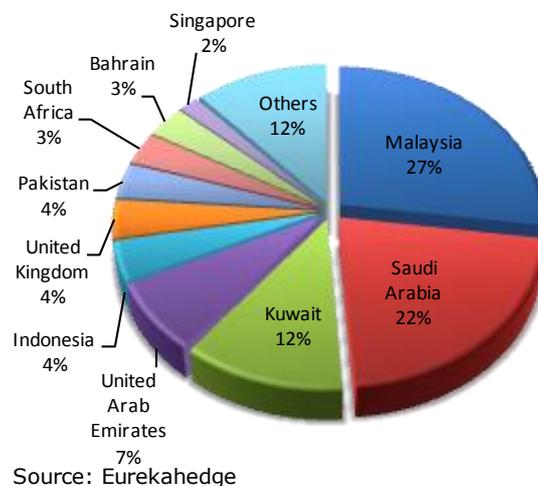
<sup>2</sup> Please go to [www.eurekahedge.com/news/attachments/KeyTrends/EH\\_IF\\_2010\\_KeyTrends.pdf](http://www.eurekahedge.com/news/attachments/KeyTrends/EH_IF_2010_KeyTrends.pdf) to learn more about the developments in the Islamic fund industry.



### Industry Make-Up and Growth Trends

Malaysia and Saudi Arabia remain as the most popular Islamic fund centres as they boast the most dynamic Islamic finance industry as well as the greatest number of investors. Saudi Arabia has recently increased its share as the fund centre of choice due to the growing popularity of retail funds among consumers as well as the emergence of Islamic bond market (sukuk) in the country. Malaysia was one of the early movers in the industry, with Islamic funds launched as early as the 1970s and further cementing its place as the leading fund centre throughout the 2000s. A liberalised Islamic banking sector with Shariah framework established in the 1980s proved to be a conducive environment for growth in the industry. Malaysia further plans to issue more licenses to foreign banks in the next three years and, as such, is set to be the leading Islamic fund centre in the coming years.

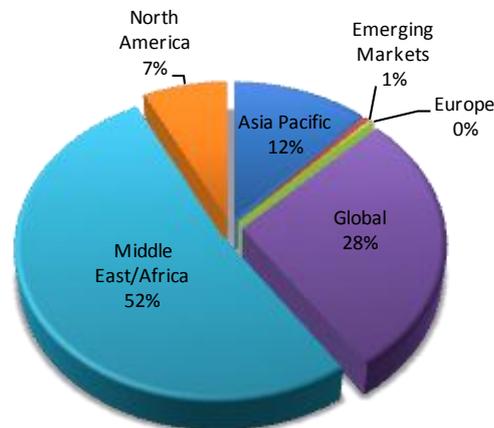
**Figure 2: Head Office Locations by Number of Funds**



### Geographic Mandates

The majority of Islamic fund assets are invested in the Middle East and Africa region primarily because it holds the greatest number of companies that are Shariah-compliant. Furthermore, other than a handful of US- and UK-based funds, Middle East-based funds boast the highest average assets under management and managers tend to invest in the regions that they are based in. Other than the Middle East, a significant amount of capital from Islamic funds is invested with a global mandate to cater to the portfolio diversification requirements of clients.

**Figure 3: Geographic Mandates by Assets under Management**

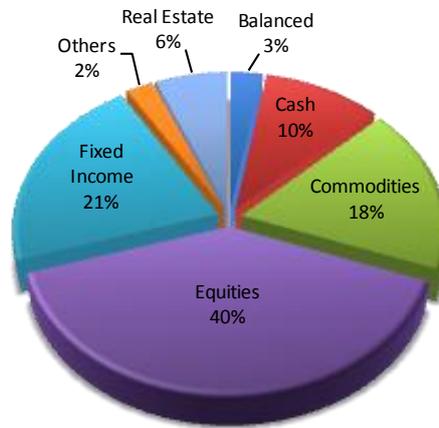




### Asset Classes

Equity investments account for 40% of Islamic fund assets primarily because allocating to Shariah-compliant companies (becoming shareholders) forms the easiest method of Islamic investment. Furthermore, equities have been the best performing asset class in the last 40 years and continue to be the most popular among investors who also find it easier to understand as compared with other more complicated Islamic finance instruments. Fixed income investments account for 21% of the assets; however, only 7% of the funds employ a fixed income mandate, showing that there are very few but large Islamic funds focused on sukuk investments. Other asset classes are, however, becoming increasingly popular as the sector develops to encompass other investments.

**Figure 4: Asset Classes by Assets under Management**



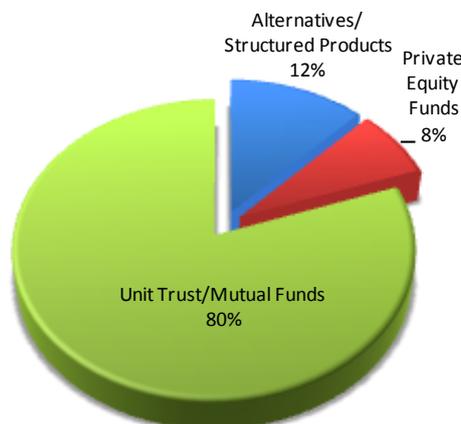
Source: Eurekaledge

### Fund Types

Since most Islamic funds cater to the retail investor, they are structured as mutual funds and other regulated products. Regulatory oversight marks a key aspect of Islamic funds and countries such as Malaysia, which have well-established Shariah regulations, would ensure compliance through government bodies – in this case, the Securities Commission of Malaysia.

While the speculative and secretive nature of most hedge fund strategies makes it difficult to ensure Shariah compliance, there are a number of Islamic private equity funds as acquiring shares of companies can easily be brought into compliance.

**Figure 5: Fund Types by Number of Funds**



Source: Eurekaledge

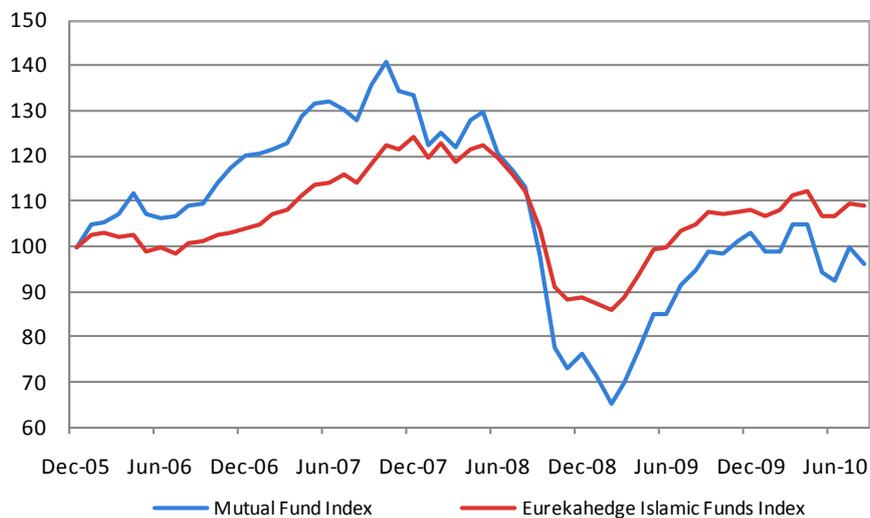


## Performance Review

Over the years, Islamic funds have delivered greater and more consistent performance as opposed to mutual funds as well as direct investments in the markets. The Eureka hedge Islamic Funds Index has gained 21.77%<sup>3</sup> since its inception in December 1999 as compared with a 30.5% loss for the MSCI World Index over the same period.

Similarly, hedge funds have delivered higher and more consistent risk-adjusted returns than mutual funds. Figure 6 displays the Eureka hedge Islamic Funds Index mapped out against the Eureka hedge Bespoke Mutual Funds Index since December 2005. Over this period, Islamic funds returned 8.99% as opposed to a 4.20% loss in mutual funds – an outperformance of more than 12%. Furthermore, in addition to better returns, Figure 6 clearly shows that Islamic funds are less volatile in nature and also provide better downturn protection as compared with mutual funds.

**Figure 6: Islamic Funds vs Mutual Funds**



Source: Eureka hedge

The results posted by the Islamic funds over the last few years show that ethical investing does not necessarily have to come at the cost of lower returns. Additionally, most of these funds are structured as mutual funds and hence, the benefits are readily available to retail investors.

Table 1 and Figure 7 compare the performance of Islamic funds investing in equities with socially responsible investing and the world equity markets.

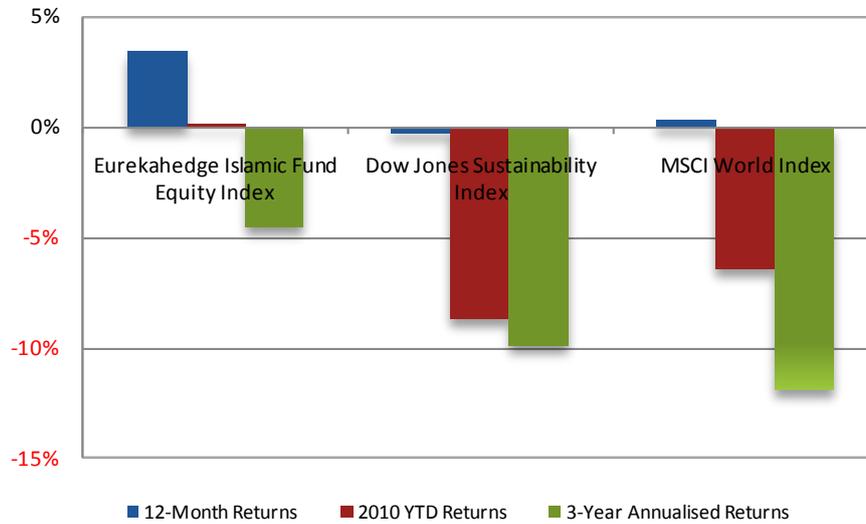
**Table 1: 3-Year Performance of Islamic Funds vs Stock Market Indices**

	Eureka hedge Islamic Funds Equity Index	Dow Jones Sustainability Index	MSCI World Index
12-Month Returns	3.43%	-0.30%	0.28%
YTD 2010 Returns	0.08%	-8.67%	-6.40%
3-Year Annualised Returns	-4.48%	-9.94%	-11.87%
3-Year Annualised Standard Deviation	18.24%	25.00%	20.38%

<sup>3</sup> All figures given are as of end-August 2010.



**Figure 7: 3-Year Performance of Islamic Funds vs Stock Market Indices**

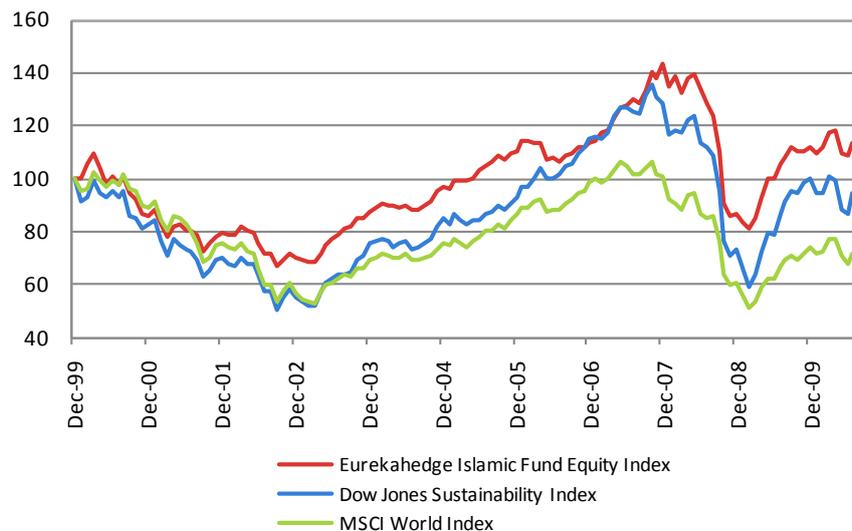


Sources: Eureka hedge, Dow Jones and MSCI

The Eureka hedge Islamic Fund Equity Index registered a 12-month return of 3.4%, beating other broad stock market indices which were either negative or flat. With the help of good risk management systems and by sticking to a limited universe of Shariah-compliant stocks, Islamic managers also outperformed traditional long-only equity investment mandates. In particular, Islamic funds avoided companies that are deemed speculative in nature such as highly geared firms. In the widely cited 'new normal' environment where credit is hard to get, these highly leveraged firms are expected not to perform very well.

Figure 8 tracks the same three indices over the longer term.

**Figure 8: Islamic Equity Funds vs Stock Market Indices over the Years**

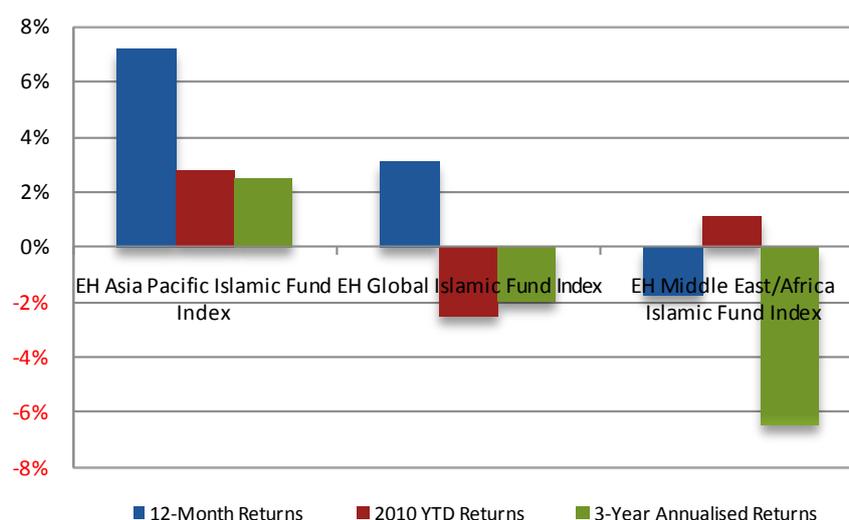


Sources: Eureka hedge, Dow Jones and MSCI



The Eureka hedge Islamic Fund Equity Index has gained 11.8% since December 1999, whereas the MSCI World Index lost 30.5% and the Dow Jones Sustainability Index was down 8.9% over the same period. Furthermore, out of these three investments, Islamic funds suffered the least drawdown during the 2008 financial crisis.

**Figure 9: Performance of Islamic Funds by Investment Geographic Mandates**



Source: Eureka hedge

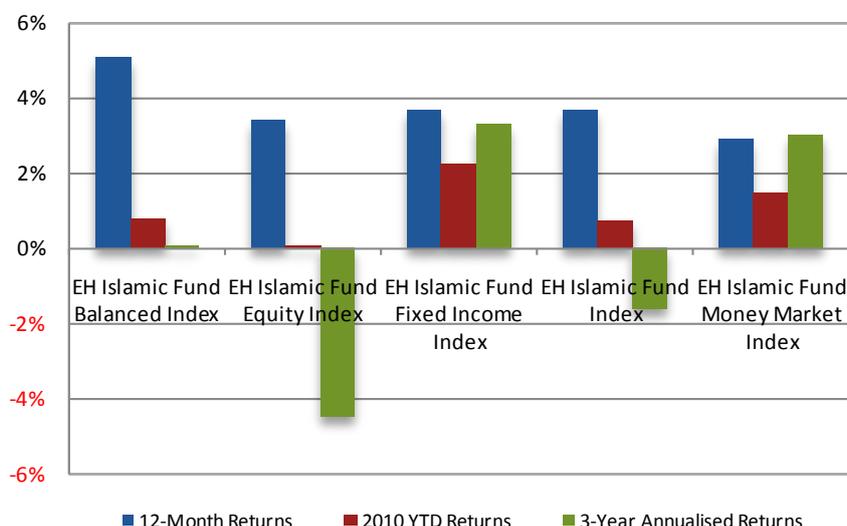
Figure 9 shows the performance of Islamic funds across geographic mandates. Islamic funds investing in the Asia Pacific region delivered the strongest performance over the past three years, 12 months and in 2010 (2.48%, 2.79% and 7.22%, respectively). A large proportion of Asia Pacific Islamic funds are invested in the Malaysian and Indonesian markets, which underwent remarkable growth in 2009 and 2010. The FTSE Bursa Malaysia Stock index jumped 11.8% YTD August while the Jakarta Composite Index was up 21.6%. Indonesian stocks have reached all-time highs and the re-election of President Yudhoyono has prompted expectations of another era of political stability and strong economic growth in the country.

**Table 2: Performance of Islamic Funds by Investment Geographic Mandates**

	Eureka hedge Asia Pacific Islamic Fund Index	Eureka hedge Global Islamic Fund Index	Eureka hedge Middle East/Africa Islamic Fund Index
12-Month Returns	7.22%	3.13%	-1.72%
YTD 2010 Returns	2.79%	-2.48%	1.15%
3-Year Annualised Returns	2.48%	-1.95%	-6.49%
3-Year Annualised Standard Deviation	11.46%	11.42%	15.81%
% Below HWM	-1.33%	-10.60%	-29.00%



**Figure 10: Performance of Islamic Funds by Instrument Traded**



Source: Eureka hedge

Islamic fund managers who were partially or fully invested in fixed income or money market instruments have registered healthy gains over the last few years. Islamic funds benefited from rallies in the Islamic bond market – the HSBC/NASDAQ Dubai US Dollar Sukuk Index, which tracks a basket of Islamic bonds, posted gains to the tune of 11.1% in the first three quarters of this year. With more capital being employed in the Middle East and Asian Islamic bond markets, managers in the sector look well set to further extend their positive run.

**Table 3: Performance of Islamic Funds by Instrument Traded**

	Eureka hedge Islamic Fund Balanced Index	Eureka hedge Islamic Fund Equity Index	Eureka hedge Islamic Fund Fixed Income Index	Eureka hedge Islamic Fund Money Market Index
12-Month Returns	5.10%	3.44%	3.71%	2.95%
YTD 2010 Returns	0.82%	0.08%	2.26%	1.46%
3-Year Annualised Returns	0.02%	-4.48%	3.32%	3.04%
3-Year Annualised Standard Deviation	12.19%	18.24%	1.09%	3.48%
% Below HWM	-9.72%	-21.97%	0.00%	0.00%

## Conclusion

The Islamic fund sector has continued to mature and develop rapidly, expanding into new asset classes as well as regions. Despite the industry suffering some setbacks during the financial crisis, Islamic funds rebounded sharply in the last 18 months and delivered excellent returns. Furthermore, the sector has outperformed not only the underlying markets but also other comparable investments such as mutual funds, showing that the quest for profit is not necessarily at odds with ethical investments.

Going forward, we expect Islamic fund managers to continue outperforming the markets while also expanding to cover new instruments and asset classes. The industry continues to gain traction among investors and we anticipate further growth through asset flows and fund launches in the next few years.