

Being Ethical is a Tough Business

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The Islamic finance market is very young but expanding rapidly. One of the drivers of that expansion is the huge amount of liquidity in the Gulf region. Another is the strong economic growth in countries like Malaysia and Indonesia. This is creating a large pool of investable assets, some of which are already Islamic. Within both regions, though, there is a move toward doing more and more investing in Islamic structures.

In spite of this, there is a dearth of good quality Shariah-compliant products. Indeed, in the alternative space there are few or no products at all.

It is highly likely that the investment industry in the Islamic sector will move in the same direction as the conventional sector, where there has been a shift toward alternative assets because of the desire to create more predictable and higher returns. This will happen in the Islamic sector as well.

Potentially, over the next few years, there will be up to US\$90 billion available to the Islamic hedge fund market. That is still small relative to the conventional alternative investment sector but it is big enough that even a small share is a prize worth having.

Part of the reason for the dearth of alternative Islamic funds is that they are very time-consuming and difficult to launch. A conventional hedge fund takes, on average, a year and a half to go from idea to market.

By contrast, it can take at least three years to launch a Shariah-compliant fund. An Islamic fund faces hurdles unknown to conventional hedge funds – constructing a Shariah vehicle and getting it approved by Shariah scholars. This takes time and patience, particularly in launching something new and untested.

Making an alternative investment of any sort to be Shariah-compliant is just the first hurdle. The second is attracting high quality managers, given that many are put off by the constraints they feel they would be faced with. The third is managing everything in a cost effective way so as to avoid creating any additional ongoing cost for the fund and hence ensure that it is no more expensive to run than a conventional fund.

Of course, there will be differences in the cost structure, but the net effect should be broadly equal. This is necessary to reassure investors that their returns will not be hurt.

The first step in creating a Shariah fund is to set up a Shariah supervisory committee, which passes judgment on the legality of the proposed fund's structure. It is important to understand that there is not one body of thought in Islam; there are several schools.

It is essential to have a Shariah supervisory committee that covers most of these different schools and get the committee members to come to some sort of agreement. If not, you could find yourself facing a challenge in the Gulf or, say, Malaysia. It is equally important to get a consensus decision instead of relying on a majority vote. At the end of the day, the entire committee needs to be comfortable with the decisions it makes.

As well, there are other specific problems with particular hedge fund strategies. Take, for instance, equity long/short, one of the principal hedge fund strategies, covering about 40-60% of the market. The key problem with equity long/short from an Islamic perspective is that shorting in the conventional sense is not acceptable. First, shorting involves selling something you do not own, and under Islamic law that is illegal. Secondly, when a manager receives the short proceeds, they are put in a bank account and earn interest – which, as is well known, is also not allowed.

The trick is to devise a new structure that retains the economics of shorting but takes away these issues while maintaining the commercial viability of the fund. It cannot just be fine from the Shariah perspective: it



is about everything coming together. In setting up an Islamic fund of funds, the real test for an underlying manager is not whether he or she is willing to give it a try but whether he or she can make money.

One other point: not only must the managers be able to work within the structure, the prime brokers must also be able to implement it.

Most of the legal documentation in the conventional hedge fund sector has been developed over the past 20 years, and much of it is unacceptable under Islamic law. This means a great deal of work with the prime brokers – reengineering their systems and rewriting legal documentation.

Let's look at what managers have to do that is different in an Islamic fund of funds. First, it would not be possible for a Shariah-compliant fund to invest in the managers' conventional funds because they will have investments in them that would not be Shariah-compliant.

Essentially, underlying managers can only run a dedicated managed account. They are offering investment expertise. In the end, this simplifies things because they are not required to run a fund.

The next thing they need to take into account is that every investment must be checked against a Shariah screening system and scrutinised to see if it meets an Islamic fund's criteria. This can be unnerving for some managers.

From the point of view of an Islamic fund of funds, the best managers are likely to be value managers, operating concentrated portfolios. They are the most suitable to work in the Shariah space where the investment universe is limited by Shariah criteria and managers need to look at the stock more fundamentally than otherwise.

One of the criticisms of Shariah-compliant funds is that if the investment universe is reduced, then returns must also be reduced. Fortunately, that is not true. Many academic studies have shown that if managers select from a smaller pool of stocks, the returns are not reduced but the volatility is slightly increased. Even that can be quite marginal if the universe of potential stocks numbers in the thousands rather than in the hundreds.

There is also the issue of the number of underlying managers. Shariah-compliant funds of funds will tend to have fewer managers than conventional funds of funds – principally because there are fewer managers who can meet the criteria of Islamic funds.

Some people say a true fund of funds needs a multiplicity of underlying managers to gain the benefits of diversification. But academic study after academic study has shown that you get 80% of the benefit of diversification by using just five managers.

Finally, even marketing a Shariah-compliant product is different. Doing business in the Islamic world is about building relationships. You need to spend time and effort to get to know the clients and understand their businesses. This can mean spending a lot of time in the region – not necessarily a hardship but not something you need to do with a conventional fund either.

Amiri Capital was founded in early 2006 by Bindesh Shah and Richard Ellis. The firm develops, markets and distributes Shariah-compliant investment products for Islamic investors worldwide and has developed its own proprietary Shariah Screening System called Amiri S3, which scrutinises about 36,000 stocks globally for Shariah compliance.

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