Islamic Instruments for Asset Management

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Islamic asset management vehicles

Islamic open ended mutual funds
- Islamic unit trusts
- Unit prices move in line with underlying shares
- Invest in listed companies and *sukuk*

Closed end funds
- Initial subscriptions
- Capital invested for a period of fixed duration
- No further subscriptions once initial offer fully subscribed
- Invest in private equity, leased assets and real estate

Islamic investment companies
- Value may be at a premium or discount to the value of the underlying assets
Advantages of funds as a vehicle for Islamic investments

Fund can accept responsibility for *shariah* compliance
  – *Shariah* monitoring in-house
  – Outsourcing of *shariah* monitoring to institutions such as Dow Jones Islamic Indices

Information provided on *haram* income or capital gains that may reflect such income

Purification
  – Deduction of income before distribution
  – Advice on how much should be donated to charity
<table>
<thead>
<tr>
<th>Islamic fund categories, 2011, %</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Equity</strong></td>
</tr>
<tr>
<td><strong>Money Market</strong></td>
</tr>
<tr>
<td><strong>Mixed</strong></td>
</tr>
<tr>
<td><strong>Real Estate</strong></td>
</tr>
<tr>
<td><strong>Sukuk</strong></td>
</tr>
<tr>
<td><strong>Other</strong></td>
</tr>
</tbody>
</table>
Objectives of Islamic funds

Growth funds
  – Aim to achieve capital gains
Income funds
  – Aim to maximise dividend income
Balanced funds
  – Aim to produce income and modest growth
Recovery funds
  – Invest in undervalued companies
Global equity funds
Regional and country funds
  – US, Europe, Japan, Asia
Emerging market funds
Portfolio investment through brokers

Discretionary
- Professionals given powers over day to day asset management
- Assets can be managed through a trust
- *Amana* is duty of a trusted person (*amin*) with absence of liability for losses except if breach of duty
- *Wakala* agency contracts with the manager as *wakil*
- *Daman* involves contract of guarantee with trustee (*damin*) liable for losses

Advisory
- Tied and independent advisors
- Commissions and fees for advice provided
- One off advice or continuous portfolio monitoring

Execution only services
- Brokerage for a modest fee

Institutional investors
- Pension funds and *takaful* operators use brokerage rather than funds
Portfolio design

Weighting
- Ratio of equity to bonds or *sukuk*
- Ratio of money holdings to investments

Liquidity
- Proportion of real estate and property
- Notice *mudaraba* deposits, unspecified and specified
- Family *takaful* investment

Balanced or skewed
- Aim of regular, modestly rising income while capital maintained
- Opportunistic, with focus on possible capital gains, but possibility of losses
Risk assessment

- Hedge funds
- Private placements
- Equity investments
- Sukuk securities
- Mudarabah investment deposits

Return

Risk

0
Screening of equity investments

Financial screens
  – Total debt outstanding does not exceed one third of total capital
  – Investment in cash and interest bearing securities do not exceed one third of total capital
  – Receivables and cash do not exceed 50% of capital

Sector screens
  – Avoid conventional banks
  – Pork production and distribution
  – Breweries and distilleries
  – Gambling and casino operations
  – Morally disreputable media including films and publications

Primary and secondary business
  – Investment in supermarkets, hotels and airlines possible if less than 5% or 10% of business doubtful from an Islamic perspective
**Musharaka versus equity investment**

<table>
<thead>
<tr>
<th><strong>Musharaka</strong></th>
<th><strong>Equity investment</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Venture of limited duration</td>
<td>Company exists in perpetuity</td>
</tr>
<tr>
<td>Partnership with joint ownership</td>
<td>Exclusive ownership by shareholders</td>
</tr>
<tr>
<td>No exit without agreement of partners</td>
<td>Exit at any time if company listed</td>
</tr>
<tr>
<td>Investors obtain profit share</td>
<td>Investors get dividends</td>
</tr>
<tr>
<td>Little probability of asset gains when venture terminates</td>
<td>Focus on capital gains and market value of equity</td>
</tr>
</tbody>
</table>
Term *musharaka* structures

- **Sole proprietor**
- **Existing business**
- **New *musharaka* partnership**
- **Investors or bank**
- **Musharaka accounts**

- **Ownership**
- **Initial investment**
- **Finance**
- **Payouts**
- **Regular profit share payments**
- **Financial reporting**
## Sukuk choices

<table>
<thead>
<tr>
<th>Sukuk</th>
<th>Conventional</th>
</tr>
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<tbody>
<tr>
<td>Salam</td>
<td>Bills</td>
</tr>
<tr>
<td>Murabaha</td>
<td>Bonds</td>
</tr>
<tr>
<td>Ijara</td>
<td>Notes</td>
</tr>
<tr>
<td>Musharaka</td>
<td>No equivalent</td>
</tr>
<tr>
<td>Mudaraba</td>
<td>No equivalent</td>
</tr>
<tr>
<td>Convertible sukuk</td>
<td>Preference stock</td>
</tr>
</tbody>
</table>
**Ijara sukuk structure**

- **Originator (advised by arranger)**
  - Sale of asset
  - Lease agreement
  - Rental payments

- **SPV issuer (law firm admin)**
  - Rental payments
  - Certificate of participation
  - Reimbursement of issue price on maturity
  - Cash

- **Islamic investors (takaful operators Shari’a funds)**
  - Buy back of asset at maturity

- **Guarantee of SPV obligations**
Value of *sukuk* issues, $ million
Value of *sukuk* issues by country, 2009 – 2010, %

- Malaysia: 47%
- UAE: 31%
- Pakistan: 13%
- Saudi: 5%
- Indonesia: 3%
- Cayman: 1%
Real estate investment

Real estate investment
- Pricing determinants

Shari’ah perspectives
- Ijara operating lease contracts

Unlocking the potential of waqf
- Islamic charitable trust leasing and securitization

Shariah compliant residential property finance
- Islamic mortgages through murabaha, ijara wa iqtina and diminishing musharaka

Case studies
- Shariah compliant property investment in the United Kingdom
- Kuwait, Bahrain and Emirates based Islamic real estate funds
- Growth of Islamic real estate investment funds and projects
Islamic real estate fund investment

$US million

<table>
<thead>
<tr>
<th>Year</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value</td>
<td>0</td>
<td>100</td>
<td>200</td>
<td>300</td>
<td>2000</td>
<td>1500</td>
<td>1000</td>
<td>1200</td>
<td>1500</td>
<td>1800</td>
</tr>
</tbody>
</table>
Conclusions

Balanced or concentrated portfolios
- Balanced for tracker funds with passive management
- Focused and actively managed funds for higher returns
- Capitalise on knowledge and skills of the asset manager

Liquidity preferences
- Listed equity and traded *sukuk* for high liquidity
- Private equity, real estate and untraded *sukuk* for higher returns

Risk preferences
- Mature listed equity, well located real estate and money market instruments for low risk
- Technology, frontier market investments and private equity for high risk and returns