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ISLAMIC INVESTMENT FUNDS: AN ANALYSIS OF RISKS AND RETURNS

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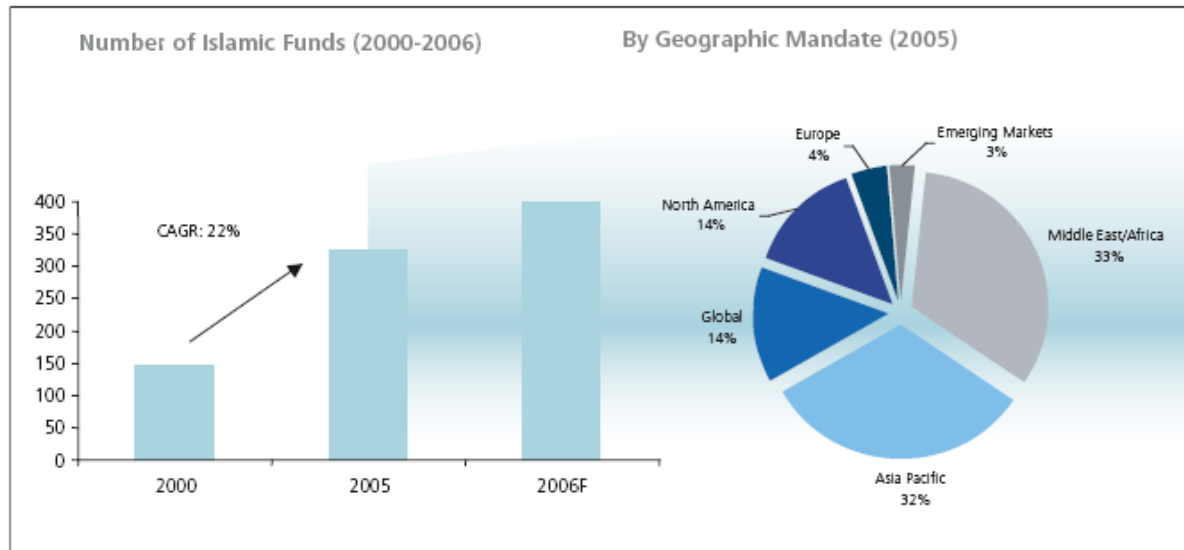
ABSTRACT

Islamic finance has become an increasingly popular subject in recent years. Some Islamic investment vehicles have even become popular in the non-Islamic world, although the growth in their popularity has been dampened by lack of knowledge of their existence, their nature and their relative profitability. This paper presents an overview of the various kinds of Islamic investment funds and analyzes their relative profitability in an attempt to shed light on this potentially high-growth investment avenue. The paper begins by identifying the various classifications of Islamic funds and goes on to discuss the more popular fund structures, the role of regulatory boards and the performance history of various Islamic funds. The paper concludes with a discussion of the challenges facing Islamic funds and the opportunities that exist for those who understand what Islamic funds are all about.

INTRODUCTION

With 15 to 20 per cent growth a year Islamic Finance & Banking has emerged to become one of the vital pillars of the global financial system. Currently more than 300 Islamic financial institutions are operating in over 75 countries, managing between \$500 billion and \$1 trillion 'dollars in assets, according to Dr. Jassim Hussain, an economist and member of Bahrain's Parliament (zawya.com). Islamic Investments Funds have had a major impact on Global Finance. Ever since the formation of Dow Jones and the FTSE Islamic Index in the 1990s, all of the different Islamic funds have not only gained momentum but also popularity with assets only on the Islamic Equity side totalling \$20 billion from almost nothing a decade ago. This growth has also been driven by the degree of Islamic orientation in the Middle East/Africa and the Asia Pacific region, which is experiencing tremendous growth. This has increased so significantly in the recent past that Islamic fund management is now a mainstream arm of most conventional banks and financial institutions. Recent estimates put Islamic Financial markets at around \$230 billion with a growth rate of about 15 percent.

Islamic Funds are considered a special case of ethical funds where in addition to the keeping out of certain sectors, such funds do not deal any business or transactions involving interest. (Source: Handbook of Islamic Banking) Moreover, it is expected to do even better with ratings agency Moody's expecting Islamic funds to flourish with more than 65 percent of funds likely to emanate from the Middle East, a region experiencing unprecedented growth. Here are some details as of 2005



- The universe of Islamic funds has grown by an approximate CAGR of 22% between 2000-2005;
- The total number of funds is forecasted to have reached 400 by 2006;
- Geographical mandates in 2005 were dominated by the Middle East / Africa and Asia Pacific regions, accounting for 33% and 32% respectively;
- North American and global mandates together accounted for approximately 28%.

This paper seeks to understand Islamic funds, their performance, the challenges they face and the opportunities that must avail to sustain their growth. In order to understand this extraordinary growth in Islamic Funds, it is important to know the different kinds of funds sanctioned by the scholars of Islamic Jurisprudence.

CLASSIFICATION OF ISLAMIC FUNDS

The following are five major categories of funds that are widely in operation throughout the world:

1. Equity Funds
2. Commodity Funds
3. Ijara Funds
4. Murabaha Funds
5. Mixed Funds.

Equity Funds

According to Shaikh Taqi Usmani, in an equity fund the amounts are invested in the shares of joint stock companies. The profits are mainly derived through capital gains by purchasing the shares and selling them when their value increases. Profits are also earned through dividends distributed by the relevant companies.

Commodity Funds

Islamic Jurisprudence allows for commodity funds that entail the purchase and subsequent sale, by the fund, of commodities for a profit. These profits are distributed in proportion to their investment.

Ijara Funds

Another type of Islamic Fund is the Ijara fund. Ijara means leasing whereby the purchased assets are leased out to third parties. In this fund the subscription amounts are used to purchase *halal* (permissible) assets like real estate, motor vehicles or other equipments for the purpose of leasing them out to their ultimate users. The ownership of these assets remains with the Fund and the rentals are charged from the users.

Murabaha Funds

‘Murabaha’ is a specific kind of sale where the commodities are sold on a cost-plus basis. Murabaha is a specific case where the buyer knows the price and agrees to the premium over the initial price (El Gamal, 2000). This kind of sale has been adopted by the contemporary Islamic banks and financial institutions as a mode of financing. They purchase the commodity for the benefit of their clients, and then sell it to them on the basis of deferred payment at an agreed margin of profit added to the cost. This type of fund can also be structured as a Sukuk and is used widely in Islamic capital markets.

Mixed Funds

Another type of Islamic fund may be of a nature where the subscription amounts are employed in different types of investments, like equities, leasing, commodities, etc. This may be called a Mixed Islamic Fund. In this case if the tangible assets of the fund are more than 51 percent while the liquidity and debts are less than 50 percent, the units of the fund may be negotiable. However, if the proportion of liquidity and debts exceeds 50 percent, its units cannot be traded according to the majority of contemporary scholars. In this case the fund must be a closed-end fund.

Islamic Mutual Funds

Islamic mutual funds are similar to conventional funds in most ways but differ with them in that they promote partnership schemes while investment in businesses forbidding:

- Transactions in un-Islamic goods and services

- Earning returns from a loan contract (*Riba/Interest*)
- Compensation-based restructuring of debts
- Excessive uncertainty in contracts as well as selling something that cannot be described in accurate details such as type, size, amount etc (*Gharar*)
- Gambling and chance-based games (*Qimar/maysir*) as well as speculation
- Trading in debt contracts at discount
- Forward foreign exchange transactions

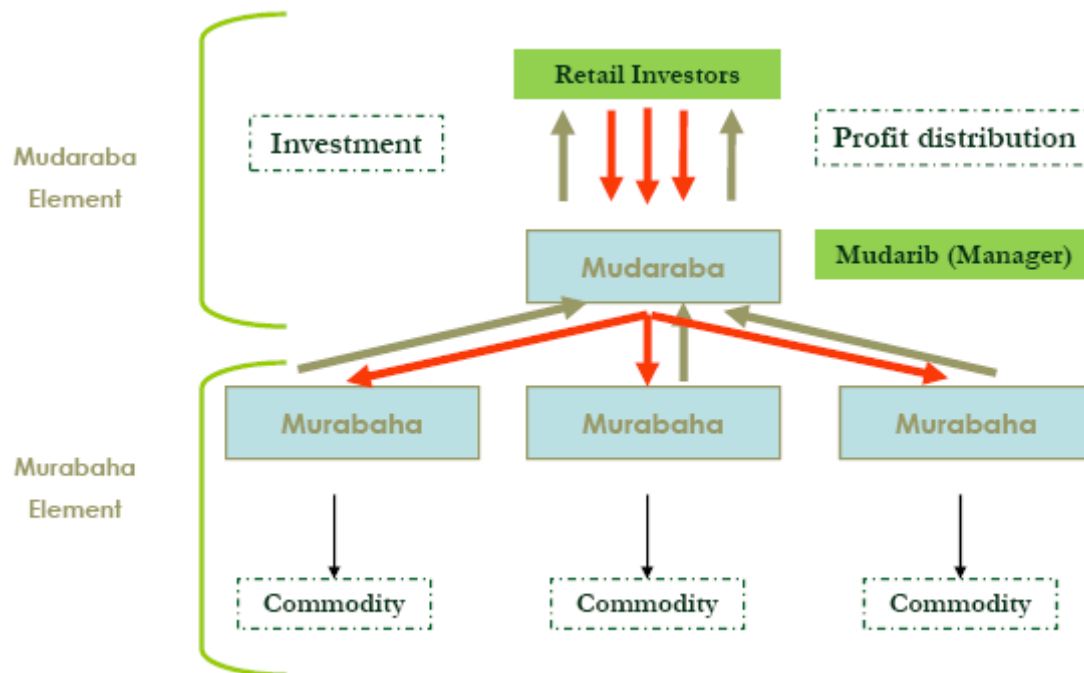
(Source: Global Investment House)

POPULAR FUND STRUCTURES

Mudarabah/Musharaka + Murabaha Fund

The following diagram is an example of a typical Murabaha Fund Structure as discussed earlier. The first part, which is the Mudarabah Element, is also used in equity funds and is interchangeable with the Musharaka where investors have more involvement in the management, than just being the Rab-ul-maal (providers of investment). In an equity fund the mudarib or mushairik would invest in the fund or hold certificates of ownership of the fund, which would then invest in sharia compliant stocks and dividends or capital gain on sale of stocks would be distributed to the shareholders.

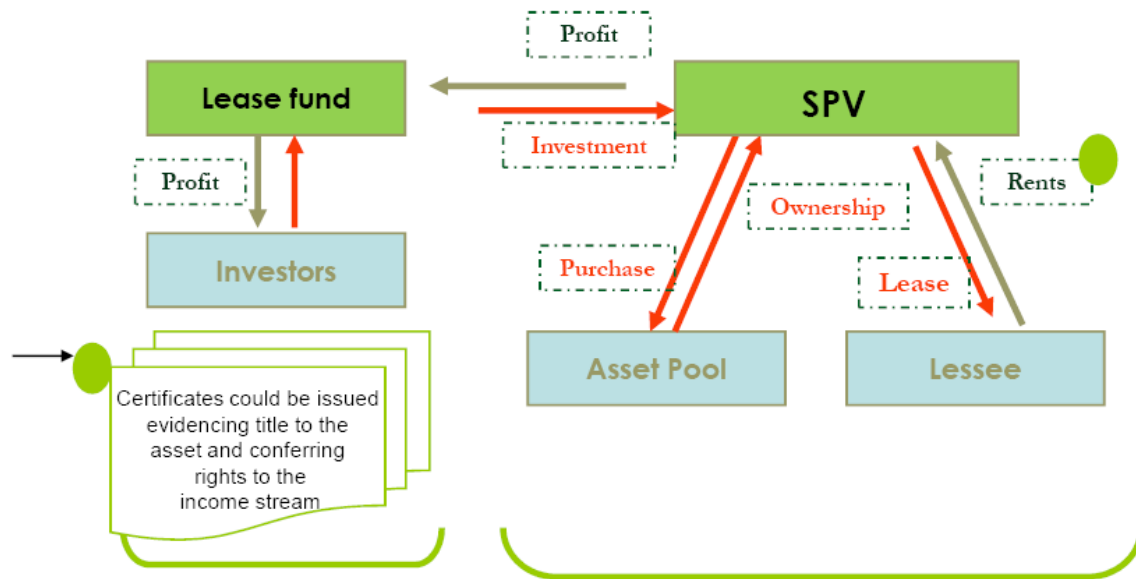
In a Mudarabah fund, the structure is similar to the Mudarabah with the difference only being in the usage of funds, where the mudarib (manager) invests in the purchase of commodities that are then sold at cost plus mark up on a deferred payment basis. The deferred payments are to act as revenues and profits earned and are distributed amongst the fund shareholders. The distribution of profits can be fixed periodically (which is the structure utilised by sukuks) or variable depending on the type of commodity or fund structure chosen.



(Source: Securities and Investment Institute – Islamic Finance Qualification Workbook)

The following diagram is an example of an Ijara Fund Structure that has been popularized due to its extensive use in structuring sukuks (part of the fixed (periodic) income asset class). In an Ijara fund the investors invest in a lease fund, which then places the investment in a special purpose vehicle (SPV), which is a company in an offshore tax free site. This SPV then goes and purchases an asset pool, which is leased out to the party requiring the assets, who in turn pay rentals for its usage. The rental income acts as the revenue stream for the SPV which in turn shares the profits back with the lease fund shareholders.

Ijara Fund



Rental stream as a source of income

Ijara incorporate a fixed term income or periodically re-fix the income stream

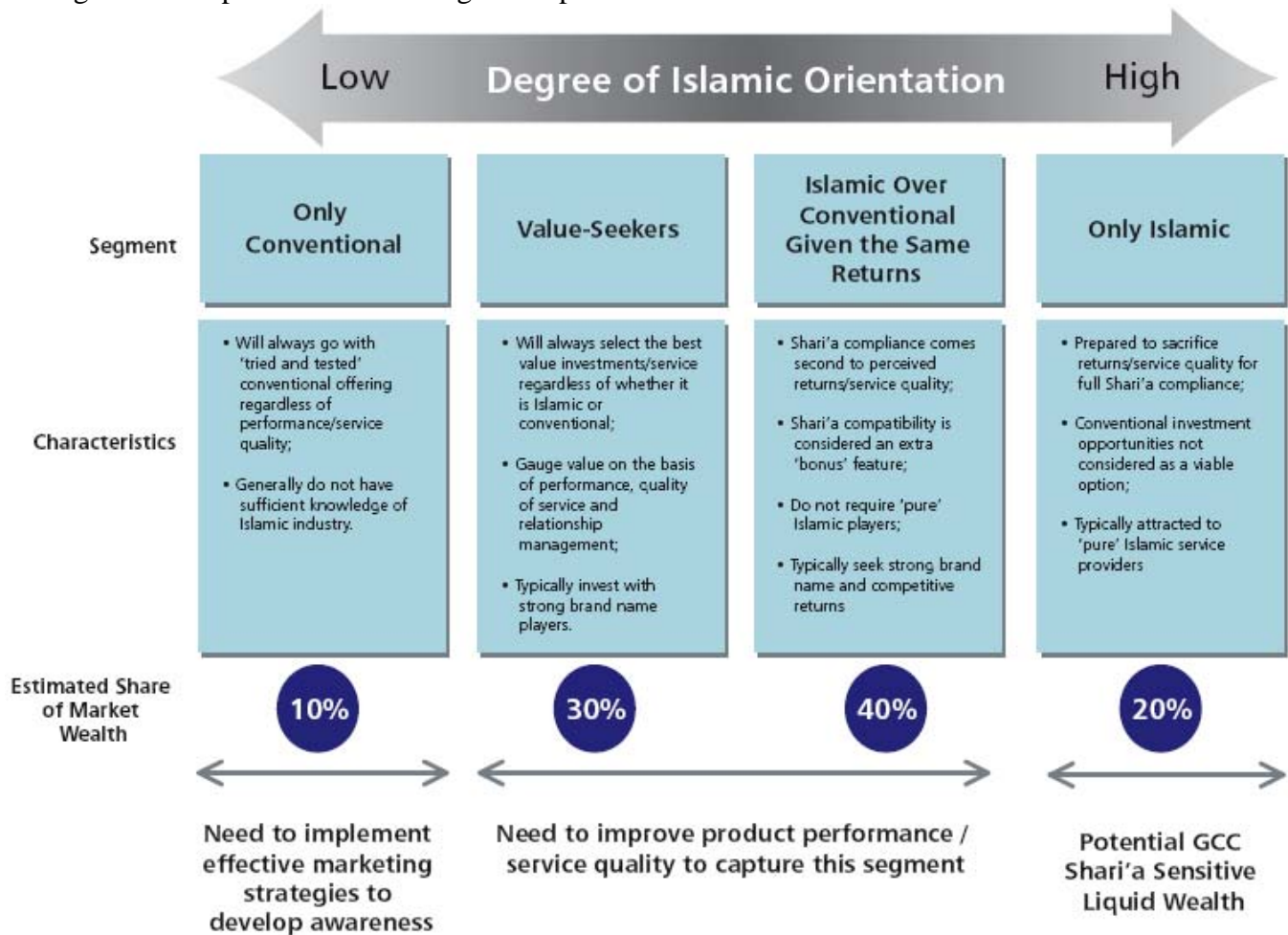
(Source: Securities and Investment Institute – Islamic Finance Qualification Workbook)

THE ISLAMIC INVESTMENTS MARKET

Although the first Islamic fund was launched on Wall Street in the early 1990's, the major Islamic funds market does not actually reside there. On the contrary, the market for Islamic funds lies in the oil rich Middle East, which is reaping the benefits of high fuel prices and hence enjoying the excess liquidity, as well as the Asia Pacific region, which make up two-thirds of the market, as suggested by an earlier figure. E&Y gives the following outlook on the Middle East region.

- Macro-economic growth in the region has been robust on the back of strong oil prices and diversification.
- Growth has 'trickled down' to individual and institutional investor segments.
- Investors' portfolio allocations indicate a need for diversified asset classes.
- Current penetration levels of Islamic funds indicate room to grow.

Moreover, since the Islamic faith is deeply entrenched in the values and culture of the region, the appetite and scope for successful alternative Islamic funds over the past decade have increased significantly. Furthermore, Islamic alternatives to traditional investment tools have been driven by the large number of Muslim investors who either only choose or prefer to choose funds that are not based on profits and not on *Riba*, i.e., interest, which is categorically haram (impermissible) in Islam. This trend is depicted by the E&Y analysis as shown below. They also give their input as to how to target the specific sector.



Source: E&Y Analysis

As stated earlier, the rise in the price of oil has been the main driver for the recent economic growth and high liquidity in the Middle East region and all of this liquidity has come at a time when the dollar is at its weakest while western markets are experiencing volatility. The figure below indicates the link between this liquidity and oil prices.

The excess amount of liquidity present in the region has led to an increase in the demand to develop profitable funds and hence the market is wide open for any financial institutions whether conventional or Islamic or new entrants to capitalize on this opportunity. This trickle down effect is evident from the following two diagrams, which illustrate the magnitude of opportunities available at the institutional as well as individual level.

Hence, it is evident the investment appetite for successful Islamic funds is only set to grow larger and with the regional financial industry in general in its infancy, gives it an opportunity to capture a large share of it.

PERFORMANCE OF ISLAMIC MUTUAL FUNDS AND THE RISE OF OTHER ASSET CLASSES

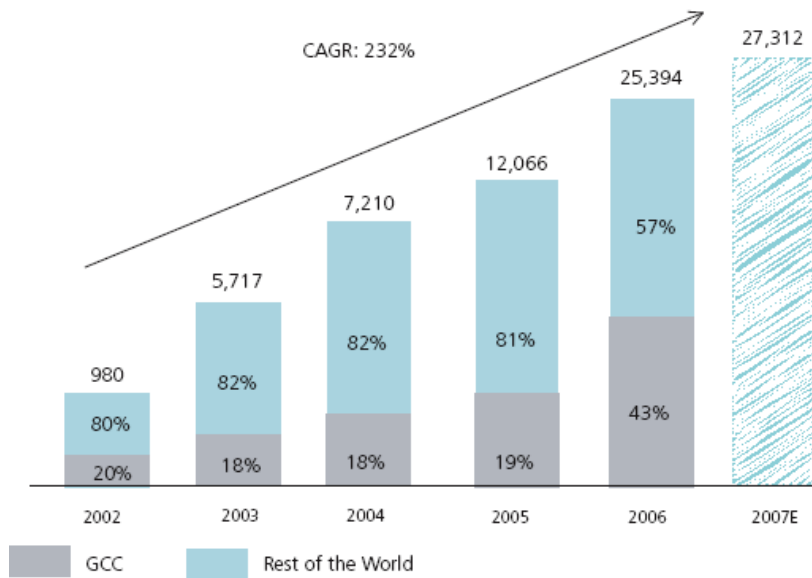
Shari'ah law based mutual funds are perhaps the most successful amongst the different funds available. The main clientele have always been Muslims looking for Shari'ah compliant funds. However, as suggest by a diagram earlier and in light of the success of several Islamic funds, Muslims who are value seekers or are indifferent so long as they get the same returns, have made the distribution channel a lot bigger.

The performance of Islamic funds has been a major reason for the attraction towards the funds. As per results of the studies examined by Elfakhani, Hasan & Sidani in the handbook of Islamic Banking, who took a sample of 46 mutual funds in eight fund categories and tracked their performances over a period of 5 years and using measures such as Sharpe, Treynor, Fama and Transformed Sharpe. The fund categories were decided according to their regional and sector investment exposure, which included global, American, European, Asian, Malaysian and Emerging market equity funds as well as emerging market Small Cap/Technology funds. The performance period covered in the study extended from January 1997 to the end of August 2002. Results: The total number of over performing funds were between 29 (63% of the sample) and 11 (29%), depending on the measure used. In terms of fund categories that were selected, four of the eight fund categories outperformed their benchmark no matter what measure was used. The overall conclusion was that Islamic mutual funds performed just as well as their conventional counterparts. Moreover, based on these results even conventional investors can consider Islamic funds for portfolio diversification purposes.

As mentioned earlier, the Ijarah sukuk is one the most popular Islamic fixed income securities where assets are typically "Ijara" contracts (leasing) but may include or utilise other forms of Islamic financing among a group of fourteen sanctioned by AAOIFI, e.g. "Murabaha" (sale of goods at a higher predetermined price payable usually in instalments), "Istisna'a" (sale of assets to be constructed/manufactured, payable in instalments) or "Musharaka/Mudarabah" (partnership), which are equity based structures. While the distribution may appear variable, it is usually possible to determine a fairly precise expected rate of return based on the underlying contracts, and the transaction documents may indicate a benchmark rate of return. (Source: S&P research)

Moreover, with project finance expected to grow to 3 billion dollars by 2012 and massive infrastructure projects in the Gulf, estimated in excess of \$1.6 trillion according to S&P analysis, major funding via means of sukuks would definitely be required. Sukuks have performed extremely well despite the recent crisis of the credit crunch in the world financial market. As suggested by the following graph, currently sukuks issues are growing at a CAGR of 232 percent is staggering growth by any standards and with the focus of Middle Eastern and other governments issuing sovereign Sukuks for large infrastructure projects, that rate will only increase. However, this particular market being in its infancy is yet to face more challenges of the financial world and stand the test of time. The successes and challenges faced by this latest addition to the Islamic assets class and phenomenon that has taken the financial world by storm is an area of research of itself.

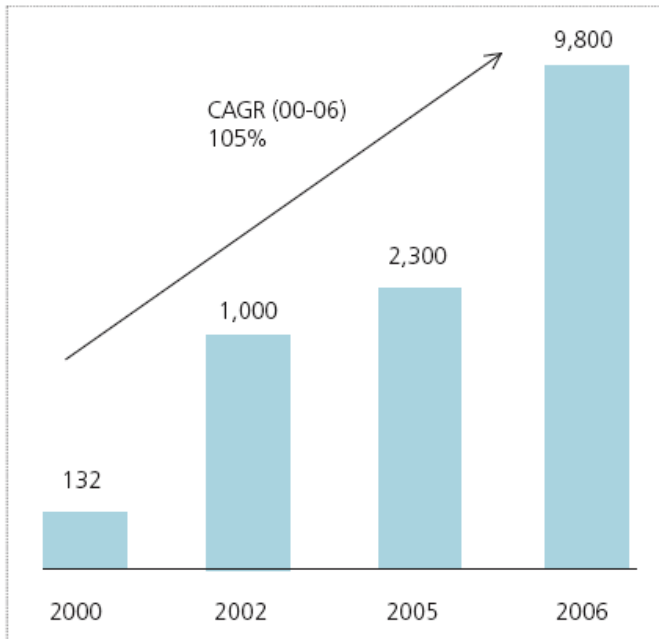
Global Sukuk Issues (USD millions)



Source: Zawya Sukuk Monitor; Islamic Financial Information Service; E&Y Analysis

Similarly, the Sukuk market private equity market is also about to witness a boom according to E&Y's 2007 Islamic Investment Report, which illustrates the growth in diversification options for Islamic investors. The diagrams below illustrate the growth in the Middle East for private equity.

GCC Private Equity Funds Raised (USD millions)



Source: Gulf Venture Capital Association, E&Y Analysis

- Approximately USD 9.8 billion raised in the GCC region in 2006
- With the recent corrections in equity capital markets, private equity has become an attractive portfolio investment asset class
- Average fund size has increased to USD 284 million from USD 230 million in 2005

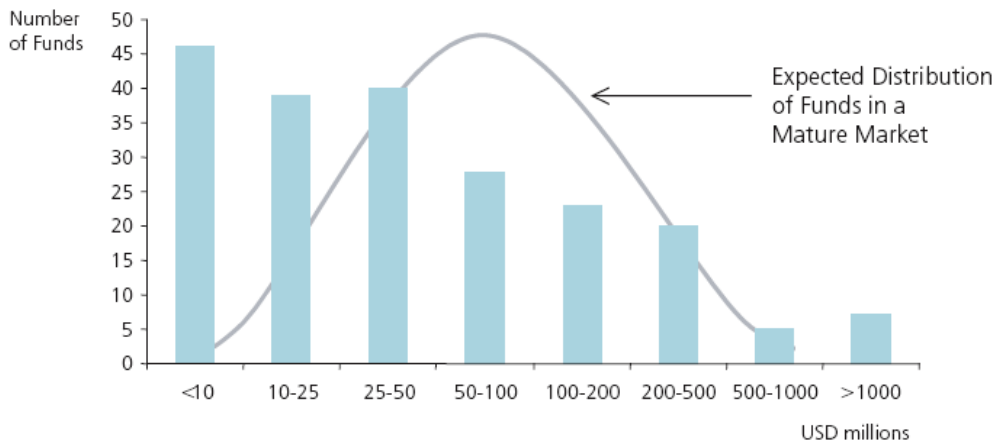
However, it is important to realise despite the growth and development of Investment funds there are still hurdles to overcome in order for Islamic investments funds to move on from infancy towards maturity.

CHALLENGES FACING ISLAMIC FUNDS

Distribution of Funds Skewed toward the Smaller Size

‘Size does matter’ is a statement that couldn’t ring more true in the world of fund management. Adequate fund sizes usually in the in excess \$50 million with many a fund crossing over into the billions. Any thing less than 10 million is considered small, which is where the majority of the Islamic funds lie. It is natural, as the phenomenon of Islamic finance is still in its infancy that fund sizes will remain relatively small. However, if Islamic funds are to compete with their conventional counterparts, then fund sizes will have to follow the trend suggested in the diagram below.

Distribution of Islamic Funds by Size (USD million)



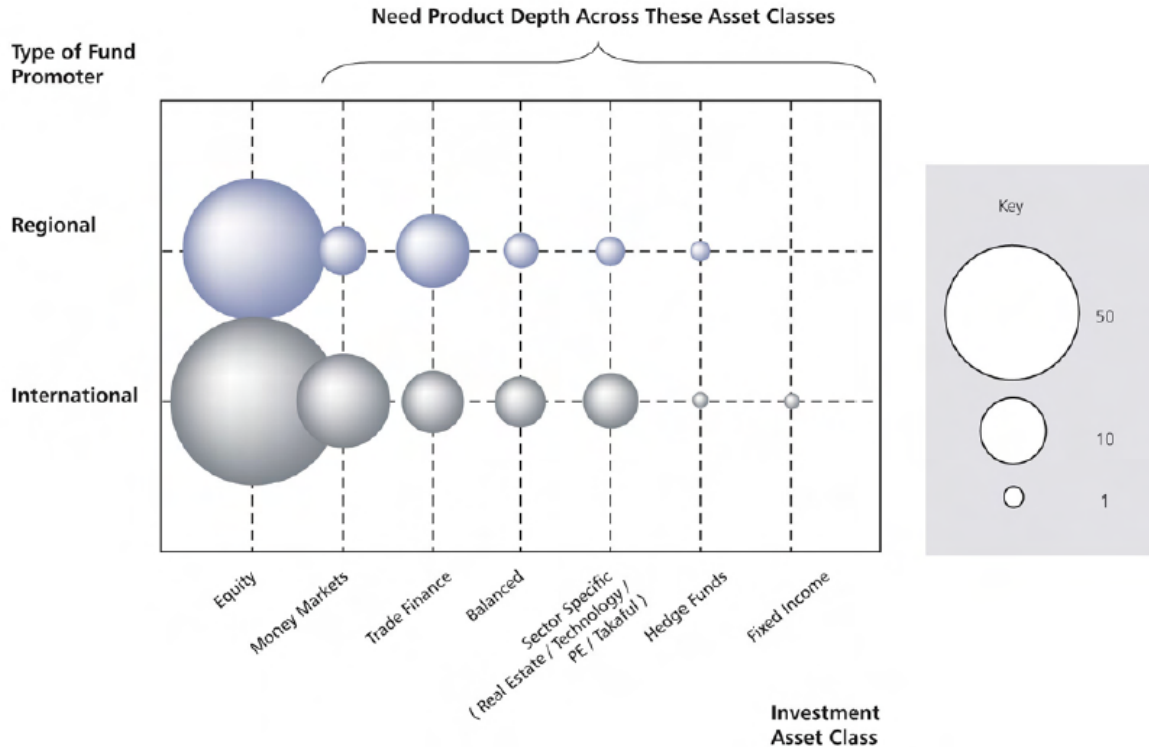
- The distribution of Islamic funds remains skewed towards smaller fund sizes
- This trend reflects the historically regional focus of Islamic funds and capacity constraints of smaller markets
- Future trends may see the increased influence of intermediation products, including fund of funds structures, resulting in a shift towards a “normal distribution” of fund sizes

Source: Eurekahedge, EY analysis

Supply of Islamic Funds Concentrated on Equities with Substantial Gaps in other Asset Classes

The majority of fund promoters in the region as well as around the globe focus primarily on the equity market whereas there are large gaps when it comes to fixed income securities, hedge funds and the other asset classes. This is an issue when it comes to creating diversified portfolios that are sharia compliant. This also highlights one of the major challenges of the Islamic finance industry, that is, the lack of sharia compliant instruments available to fund and asset managers. The following chart clearly illustrates this concern. It is quite heartening to see that the private equity and the Sukuk, i.e., fixed income market are strengthening. However,

more variety in Islamic asset classes is the need of the hour, which will only strengthen the funds by lowering risk and ensuring sustained growth and profitability. Islamic hedge funds are starting to emerge but are extremely controversial as they are disallowed by the majority of Shari’ah boards and hence till some viable, sharia complaint structures emerge, it is highly unlikely that this asset class will see as much growth as others.



(Source: E&Y Analysis)

Regulatory Challenges- No Universal Shari’ah Standards or Governing Entity

At present there is no global body governing overall Islamic finance practice. The proverb “one man’s meat is another man’s poison” exemplifies the state of affairs in this regard. A lot of the fund structures that are considered acceptable by one board are unacceptable by the other or acceptable by one scholar and not by another. This sends out mixed messages to those interested in the Islamic funds market and deters a number of potential clientele from investment in the funds altogether.

An example of this was a recent case where one of the prominent scholars sitting on several boards. Shaikh Taqi Usmani went ahead and described 85 percent of the sukuk structures as not being Shari’ah compliant. Such verdicts can shake the very confidence in Islamic funds and finance altogether, but fortunately did not dent the progress of Sukuks much, as other eminent scholars weren’t in complete agreement. The major reason why Islamic finance institutions have been unaffected by this is mainly due to lack of knowledge or even ignorance of the Shari’ah compliance of the investors, which in itself is a major problem that will be discussed later.

However, as the surge in Islamic jurisprudence, particularly finance related jurisprudence, is a relatively new phenomenon, hence debates will likely occur especially as most of the scholars belong to different schools of thought and backgrounds. Such debates are

actually encouraged so as to produce truly Islamic ally viable solutions and increase awareness amongst the public about Islamic finance in general. This will also certainly reap benefits in the long run as part of the process to creating a universal set of Islamic principles and standards such as GAAP (Generally Accepted Accounting Principles) as homogeneity in regulations is becoming vital as this industry moves from infancy to maturity.

According to IMF's Juan Sole, the ideal roles that should be played by a supervisory board can be summarized as the following:

- Ensure Shari'ah compliance i.e. whether Islamic banks' activities are compatible with the Shari'ah. In some countries, private Islamic banks have their own Shari'ah advisors. However, setting up a Shari'ah consultative board at the supervisory agency would be beneficial in countries where Islamic banks are present.
- Prudential supervision, as is the case in conventional systems, the supervisory authority must ensure the stability of the financial system as a whole, as well as the proper conduct of individual institutions. Therefore, the regulator will have to undertake similar supervisory and regulatory functions regarding Islamic institutions as the one already performed vis-à-vis conventional institutions.
- Safeguarding interests of investors and stakeholders in general - Demand depositors in Islamic banks face the same risks as demand depositors in conventional banks and thus merit the same level of protection.
- Systematic considerations -While the failure of a corporation would not have contagion effects, the failure of a bank or institution could very well result in the public's loss of confidence in the stability of the banking system as a whole, thus triggering a generalized bank run.

Lack of Knowledge and Understanding of the Islamic Funds

One of the major issues faced by the industry in general but particularly by Islamic funds is the lack of knowledge and understanding of its functioning. One of the reasons cited is that Islamic fund management firms have not done a good enough job in marketing themselves, whereby they differentiate themselves from their conventional counterparts.

Furthermore, the limited number of educational institutions teaching Islamic finance around the globe doesn't help the cause either. Hence, creating awareness at the grassroots level by having open lectures, seminars, courses and degree programs that would only benefit the industry. This role is not limited to fund management firms but is also comes under the duty of regulators, who uphold the Shari'ah law, to increase awareness through transparency as well as a forum to explain their rationale for different laws. Moreover, it has become critical to have educated staff, i.e., relationship managers, investment advisors and other professionals who are just as well versed in Islamic finance as they are in conventional finance to educate their clientele. This would be the best source of education.

Limited Implementation of Corporate Governance Practices

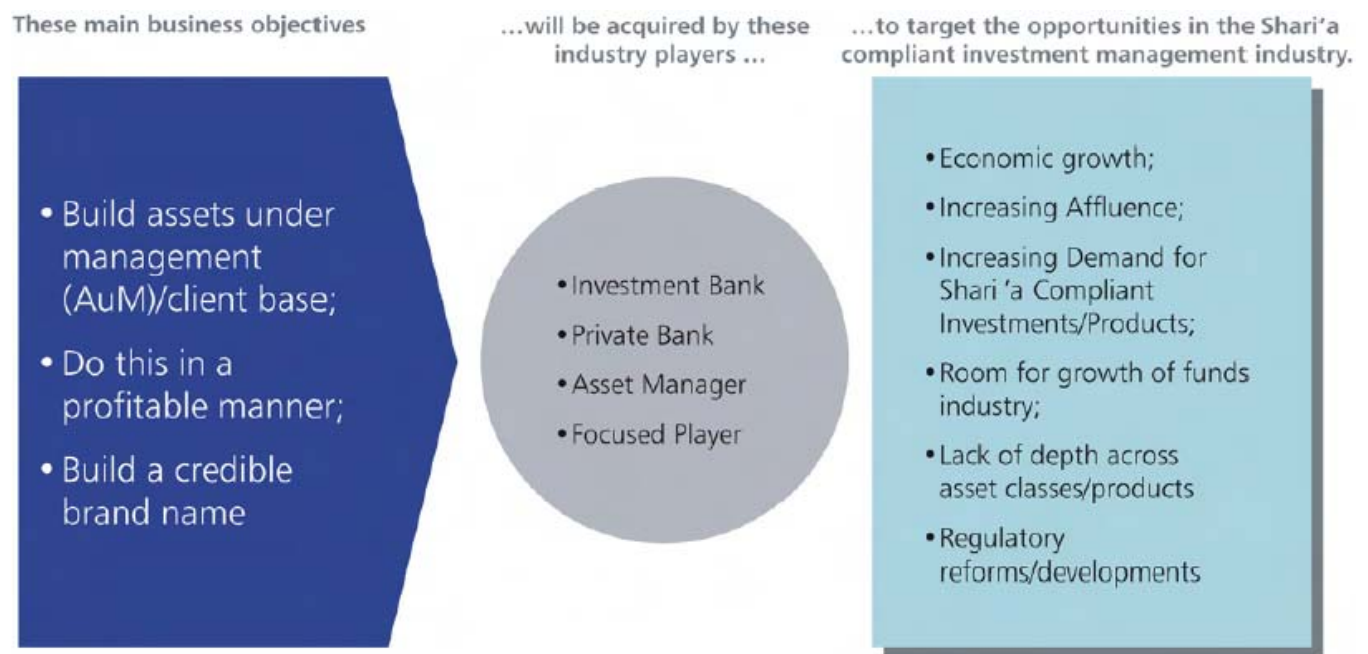
As highlighted earlier, without the Shari'ah scholars there is no Islamic finance. However, there is growing concern about the increasing amount of dependence on scholars and taking their *fatwas*, i.e., opinions, as decrees etched in stone. Some fear this could lead to the monopolization of the industry in the hands of the few, which could have detrimental effects on

the industry in the long run. Moreover, for more than a little while now the overall practices of Islamic banks and financial institutions seem to be unknown entities to most investors and others alike. Moreover, understanding the basis of these fatwas and reasoning behind them needs to be explained better in order to maintain trust in this ethically driven industry. Simply citing the lack of knowledge of the process of deriving fatwas will not fly much longer with investors or critics, especially as the industry is now moving into the major league of the financial world.

Hence the push towards strong corporate governance practices and for more transparency is a good sign for the industry but is not being received very well by all the major players within the industry, who are not accustomed to these standards that are mandatory on the conventional side. However, it is critical that these standards be put in place now, prior to any foul play occurring that would shake the confidence in this budding phenomenon.

OPPORTUNITIES

Islamic wealth management has tremendous potential to pick up the slack in the area suggested in the earlier discussion. The growth of Islamic wealth management will force Islamic finance professionals to tap into new asset classes and develop new funds for better diversification and portfolio management.



(Source: E&Y Analysis)

According to Ernst & Young's 2007 Islamic Funds report, in order to target the opportunities presented in light of the above discussion, Islamic financial institutions will have to meet the objectives as indicated in the diagram below in order to gain a solid footing in the market and capture the two segments indicated in the diagram earlier, i.e., the value seekers and Islamic over conventional, which make up 70 percent of the market.

As depicted by the diagram below, this can be achieved by:

- 1) Having staff qualified in Islamic finance and with strong expertise in asset allocation and portfolio management would produce a truly winning combination. As indicated by the diagram below, strengthening the entire chain by having *qualified* professionals in each of the four areas that understand and are able to develop and market sharia compliant products but also keeping them motivated by providing them with training and development programs as well as growth incentives to keep them in the organisation. This is critical particularly in this part of the world, where education is scarce and employee retention can be exemplified by a revolving door.
- 2) Developing strong corporate governance standards by having strong, efficient and effective management practices is just as crucial as having the expertise. This will increase transparency and reliability throughout the chain while reducing systematic risk. This also puts the interest of not only the investors but all other stakeholders, which includes the society at large. Being an ethically or morally driven industry, having transparent operations working efficiently and effectively is a critical factor in taking advantage of this opportunity.



(Source: E&Y Analysis)

PRIVATE EQUITY

Private equity is perhaps the hottest segment of the Islamic funds market. A growing number of fund managers are now resorting to private equity (P.E.) for more than just diversification. Based on the E&Y analysis, P.E. firms have made investments in excess of 3.7 billion dollars in 2006 and aren't showing any sign of slowing down, as their CAGR for the past 4 years has been about 130 percent.

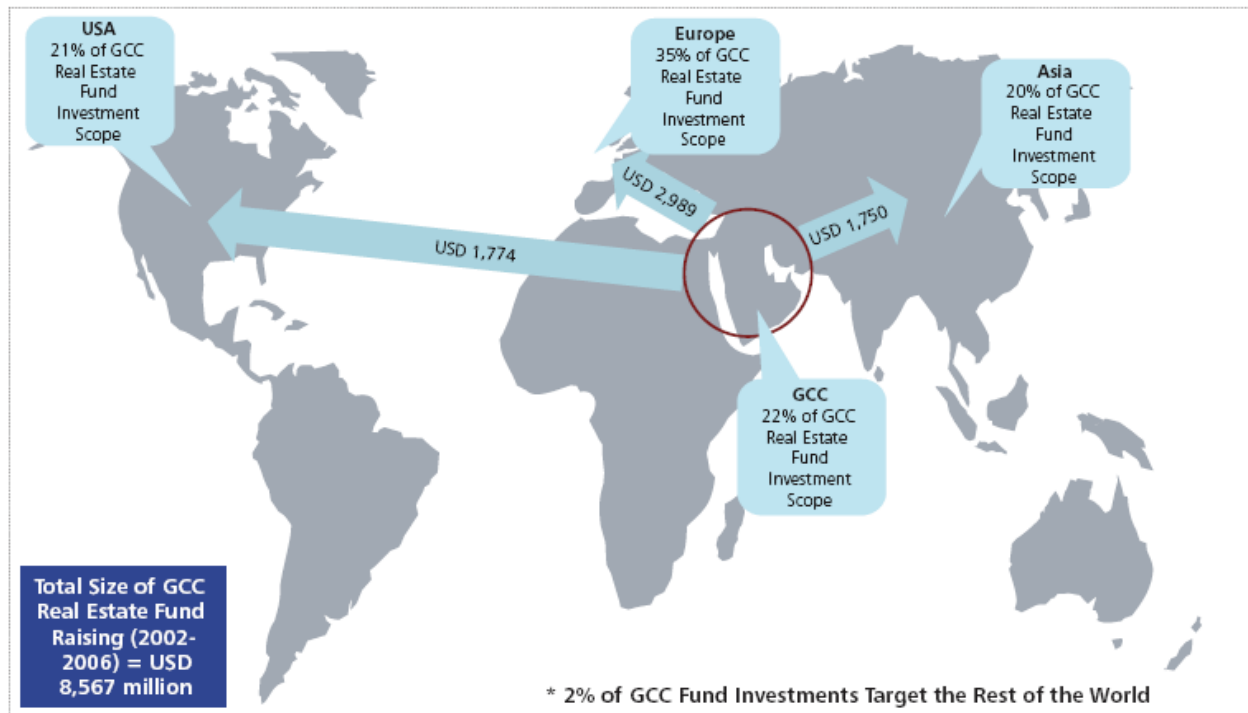
E&Y further goes on to state that private equity has hit the right chords and will only grow bigger in this region based for the following reasons:

- Economic Growth
- Increased Privation
- Development of Capital Markets
- Legal Reform
- Cultural acceptance of Islamic Products

REAL ESTATE FUNDS

As stated earlier, project finance is on the rise and is expected to reach 1.6 trillion dollars by 2012 with a major chunk of that being real estate projects. Hence, the time is ripe for the Islamic real estate funds to cash in on the monstrous projects being undertaken all across the Asian continent, consequently adding a new dimension to world of Islamic funds. Real estate has been the most popular investment for most conventional private equity firms in the region. As the major markets in the region, which include the Middle East, India and China, continue to grow, so will the prospects of Islamic real estate funds. Another long term opportunity is North America, which is coming out of the recent housing crisis. With lower housing costs, Islamic real estate funds are ideally positioned as the oil rich investors of the Middle East would be more than willing to enter into this market. The latter figure clearly indicates the trend of investments of real estate funds:

Size of GCC Real Estate Fund Investment Scope 2002-2006 (USD millions)



CONCLUSION

It is readily evident that Islamic finance, particularly Islamic funds, is here to stay. As per the UK based Securities and Investment Institute, through working closely with scholars and

regulatory authorities it appears that solutions can be found to the problems that have inhibited the development of new investment products and the choice available to investors is increasing rapidly. The Islamic finance sector is a fairly cautious one, which is a factor any financial institution must bear in mind before launching new Islamic alternatives to conventional products, as any mishap in terms of compliance would not only damage the institution but also the industry. But it is evident from this paper that with Shari'ah backing/authentication, efficient and effective management support and a strong investment strategy, any financial institution can look to gain substantial ground in this growing field.

As this phenomenon continues to grow, standardisation and a better overall education system is required to sustain its strong upward growth. This will not only bring stability but also much needed innovation, which presently is the job of a handful of experts. With the formation of the different boards and standards, Islamic funds are well on their way to becoming a viable mainstream investment in the world financial market.

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