Islamic Funds Play a Disappearing Act
By Tariq Al-Rifai - October 23, 2000

BACKGROUND
Islamic equity funds have experienced excellent growth during the 1990s. The progress equity funds have made over a short period of time would have been unimaginable just five years ago. Funds didn’t catch on until 1996 when there were roughly nine equity funds on the market. Today, there are over 90 funds on the market and over ten new funds expected to come to market this year, bringing the total to more than 100.

The reasons for the growth are simple; acceptance of equity investments by Sharia scholars, strong performance in world equity markets, and demand by Muslims to see more investment alternatives. As a result, Islamic equity funds have grown from just $800 million in total assets (for all funds) in 1996 to about $5 billion today. That’s a 50 percent annual growth rate over the period.

THE PROBLEM
Upon closer examination of the industry, it is clear that problems exist that will cause investors to lose confidence in Islamic funds if not corrected soon. Several fund managers have already lost interest in the market such as Flemings and PFM Group.

Up until recently Flemings was considered a pioneer in the industry for having launched the Oasis International Equity Fund early on before many Islamic institutions took notice of the market’s potential. However, the Oasis fund recently closed and was liquidated due to lack of interest in the product and poor distribution capabilities among other reasons. PFM closed its Ibn Khaldoun International Equity Fund over a year ago for similar reasons.

These cases are not unique. Faisal Finance, a subsidiary of Dar Al-Mal Al-Islami (DMI), recently decided to close and liquidate its Egyptian Equity Fund and at least two more funds will probably follow the same path soon. There are already a handful of funds that have experienced high redemption rates this year. So what are the underlying reasons other funds need to consider to escape the fate of their former peers?

REASONS
The key to success for any fund is distribution. If a fund does not have a large enough client base or does not have the ability to sell, it will not succeed. Also, it cannot sell something nobody wants to buy no matter how large a client base it has. Some Islamic equity funds, unfortunately, face these problems and more.

Based on the figures given above, we can conclude that the average size of an Islamic fund is $50 million, which is a small figure by global fund standards. However, in looking at the size of each fund the results are much different. Islamic funds sizes range from $500,000 to $750 million, with most of the funds having less than $35 million in
assets. This paints a poor picture of Islamic funds in general. Why are there so many funds in such a small industry?

Over the past few years Islamic funds have been excellent performers. This is mainly the result of the performance of the technology sector where Islamic funds invest a higher portion of their portfolios. So then, why haven’t Islamic funds attracted more assets?

When funds were first launched they tended to target the high-end of the market looking to capture the high net-worth clients. Some of the early funds succeeded even as copycat funds began to appear. The industry as a whole was geared towards the high net-worth segment, with few exceptions, most notably National Commercial Bank (NCB) and Al-Rajhi Banking Group of Saudi Arabia. These two banks, along with most Malaysian funds, have large retail networks in their respective countries, which proved to be very rewarding.

The most successful funds were from these institutions, especially since they were less dependent on a few large clients. More importantly, they have proven distribution channels and understand their clients’ needs.

If we look at the less successful funds we see that they were mostly targeting the high net-worth market, had no clear distribution capabilities, and in many cases overlooked what the customer wanted. As the high net-worth segment became saturated, funds began competing for what little money was left looking for Islamic products.

There are currently 32 global equity funds on the market and several more will be launched before the end of the year. One can only conclude that these new funds will cannibalize others which will be forced to liquidate or open up new distribution channels.

SOLUTION
To solve the distribution problem, the best solution would be for funds to partner with financial retailers such as the relationship between NCB and National Bank of Kuwait (NBK), where NBK opted to distribute NCB funds instead of venturing off on its own. This strategy has proven very rewarding for both institutions. Today, NCB is clearly the largest player in the field with Al-Rajhi a close second.

The suggestion above is not a cure-all solution. Fund managers must also develop products customers want. Launching another global equity fund only makes sense to those institutions with retail networks. New players must look for untapped potential in other segments of the market. Study what the target customer base wants first and then develop products to serve them.

It is inevitable that more Islamic equity funds will disappear, but at the same time, those with proven success will gain a stronger foothold in the market. This year will be known not only as a year of market corrections, but also the year of Islamic fund corrections.