Pulling Arab funds into Malaysian shores

The size of global Islamic funds has dramatically increased since the incident of September 11. Investments particularly from Islamic institutions and wealthy Muslims have shifted from conventional based funds to Islamic funds. Back in 1999, these funds were estimated at about US$800 million and now up to US$200 billion. It is interesting to know who manages them or where they are now. The label "Islamic funds" suggests that they are run under strict Shariah fundamentals. Funds may be invested in Shariah compliant stocks and *sukuks* (bonds), real estates, properties and infrastructure projects.

Among the early Islamic funds were Mendaki Growth Fund (Singapore), Southern Pure Specialist Fund (South Africa), Al-Rajhi Local Sare fund (Saudi Arabia), and Tabung Ittikal Arab-Malaysian (Malaysia).

It is common sense to say that people engaging in Islamic funds are aware of two things, i.e. first, the fundamentals of investing and second, the fundamentals of religion. The former usually implies doing things right. It concerns efficiency and profitability. This is the *tabi'* aspect of financial market activities. *Tabi'* means natural. It is nature's way to run business efficiently. *Tabi'* values are universal values. Once found, these values can be used by all people, irrespective of faiths and beliefs. Market players apply knowledge accumulated from reason and experience to understand how the market works and operates, which is a natural thing to do.

On this note, knowledge derived from non-divine sources cannot be downgraded as ungodly. In Islam, *'ainul yaqin* refers to the knowledge derived from sense perception, namely material *(jismani)* and facts *(haqiqi)* wherelse *'ilm-ul-yakin* is based on reasoning *('aql)* and human judgement *(khayali).* For example, to reduce cost per unit, the company should increase output. This is economies of scale. To increase sales, it should first conduct marketing research. To look for a credible partner, it should conduct due-diligence and so on. The *tabi'* aspect of business cannot be ignored even when it runs under an Islamic label. Muslims and non-Muslims alike are assumed to obey the *tabi'* law.

Working against this law is only inviting disaster and chaos. Business is doomed to fail when the *tabi'* law is ignored.

This is true because, business must do things the right way. To perform well, they are expected to sell the right product at the right time and to right people. Likewise in Islamic funds, the sale and purchase of financial assets demand knowledge about economic fundamentals and appropriate investment strategies that work well within a market setup. For example, few years ago, Islamic funds in the US have been excellent performers as the bulk of their portfolio was invested in the high-performing technology sector. But when funds do not perform as well, early redemptions and liquidation are next on the line.

Many early Islamic funds did well because they were able to capture high-net worth clients. When more new funds are set up going after the same people, it is hard to see how these funds can perform. Then, distribution is next. The distribution channel is crucial to guarantee success. With a large client base, Islamic funds should not be desperate chasing after the already high-end saturated market. Malaysia's Islamic funds are known for its strong retail network. Strong distribution capabilities can mean tapping new markets and developing new products.

Product development now puts the Shariah in the centerstage of Islamic funds. Opinions of Shariah scholars are sought after to secure Islamic legitimacy of funds. These scholars are now called Shariah advisors and they sit in many institutions entering into Islamic fund management.

Shariah advisors today can be categorized into two main groups. They differ not by virtue of *mazhab* i.e school of jurisprudence (*fiqh*) but theology (*kalam*). One group seems to adopt the *Mutazila* school of theology where reason has pervade revelation. In Malaysia, they have approved sale-buyback (*bay' al-'inah*) and debt trading (*bay- al-dayn*), while in the Middle-east they have approved *tawarruq*, latest is the Islamic hedge funds. They say that the Shariah approves this method of wealth creation because the Arabic word *tahawwut* indicates the same. By doing so, the group found it permissible to bet against the market. If they feel share prices are overvalued, then they will short-sell. And they will make tons of money if indeed the share prices drop.

But what if prices go the wrong way? So, it is important that this group remind their high net worth Muslim clients about the plight of Long-Term Capital and George Sorros Quantum Fund. Or how hedge funds had contributed to the derailment of economic growth in many emerging economies in the 1997 Asian financial crisis. It is also critical to further make clients understand well the difference between hedging and gambling or between hedge funds and hedging.

The second group of Shariah scholars represents the majority of the Muslim thinking. In this case, relevation rules over reason. Reason is useful but it must not overpower explicit Quranic rulings on Islamic transactions. Most funds approved by this group of Shariah advisors are equity funds.

There are many types of Islamic equity funds around. Global Islamic funds are usually Arab such as the NCB Global Trading Equity and Al-Baraka. Most Malaysian funds are country funds while regional funds include Al-Rahji Middle-east and Al-Nukhba.

Efforts to bring Middle-east capital into Malaysia via the unit trust industry should prove successful. Malaysian financial assets, despite slowdown in the global economy, should be a good buy as the fundamentals are quite sound. With US$75 billion foreign reserves and relatively low external debt, an export-oriented economy like Malaysian has performed well so far and can do even better if the ringgit is revalued. With low interest rates keeping investment up, Middle-East Islamic funds should be coming in.

The next thing Malaysian unit trust companies can do is to see what the Arab investors actually wanted. This is where some drawbacks seem inevitable, as they usually concern tastes and preferences tied to religion. Malaysian Islamic bond funds as well as mixed equity funds may not run well with the Arab capital, given that these funds are invested in *bay al-‘inah* and *bay al-dayn* securities still prohibited in the Middle-east. It is also worrying that the Securities Commission's

Shariah stock screening is being seen as too liberal vis-a-vis the Middle-eastern counterpart. For example, the capital structure aspect of companies are not imputed into the SC screening model. Although no drastic corrective measures seem forthcoming, the following options are worth considering:

1. Global Sukuks issues by local companies: Global sukuks are now very popular in the Middle-east. As trust certificates, global sukuks have gained global acceptance that Malaysian companies can use to raise capital. This should reduce the portion of Malaysian Islamic bonds (IPDS) in the fund portfolio, especially the mixed fund.

2. Re-Screening of Shariah stocks: Malaysian unit trust companies (UTMC) should be able to offer a new Islamic equity fund that adopts Shariah screening method acceptable to Middle-Eastern investors.

3. Gobal Sukuk funds: When Malaysian companies have chosen to use Global Sukuk to raise capital, a Malaysian Global Sukuk Fund is next on line.

It is important to note that divergence in views concerning Shariah products today seems to evolve around disagreement (*khilaf*) concerning the fundamental of religion (*usul*), which is serious. The long-term impact can hurt local UTMCs which may find it hard convincing Arab investors about Malaysia's Shariah standards. But by embarking on the above options, Islamic funds in Malaysia should be able to penetrate Middle-eastern market, assuming that our outstanding network of distribution and retail can be replicated there.

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