CHAPTER 8

Islamic asset management: the distribution puzzle

8.1 Introduction

The major catalyst for the development and growth of the Islamic finance industry in the twenty first century has been the rapid pace of economic growth and accumulation of wealth in the Gulf States and amongst the Muslim populations of the Far East. This catalyst has driven Islamic retail, corporate and investment banking and stimulated developments in asset and wealth management. Islamic asset and wealth management – the former being the manufacturing arm of Islamic products, and the later being the sales and distribution channels for this product - are the relative newcomers of a young industry.

8.2 Islamic asset management

In regards to Islamic asset management, product development and the manufacture of Islamic funds has been commendable. The Islamic fund universe has grown at a strong pace. As an example, in 1996, there were approximately 40 Islamic equity funds whereas in 2010 the total universe has grown to more than 800 across various asset classes. This suggests substantial growth in the number of organizations involved in Islamic asset management in a space of less than 10 years.

Equity exposure dominates the Islamic fund universe with over 52 percent of the total number of Islamic product being equity funds. In terms of AUM, these equity funds represent almost USD 20 billion of the approximately USD 50 billion universe. A distant second goes to private equity and real estate offerings with a combined 18 percent of the total followed by money market, balanced and fixed income. Within the universe of equity products, the majority fall into the categories of Malaysian or GCC equity. This means that building a diversified portfolio with global Islamic equity exposure has been challenging for the Islamic investor. The industry is not only limited by the opportunities for diversification but also marked by considerable concentration. The top 20 Islamic funds (by AUM) make up more than 60 percent of the fund universe. Although the number of products has grown and the Islamic fund universe now offers far more diversification than was available 10 years ago, in terms of asset classes there are still large gaps. There are legitimate reasons that need to be considered here. In the conventional industry, there is a great deal of diversity of funds but most of this is concentrated in the US and Western Europe. Not many emerging economies at a level of development comparable to that of Malaysia or the GCC have a significantly high degree of product diversity. It is fair to say that the limitations are, to a significant extent a function of broader economic and financial sector development. Hence Islamic fund managers can only create a fund when the components exist. The lack of sukuk funds for instance, has been ultimately mainly due to the lack of sukuk issuance and secondary trading.

8.3 Islamic wealth management

Islamic wealth management is still very much in its infancy. But it must be kept in mind that financial services in Muslim countries, especially the GCC, are also young. The Saudi banking sector emerged as recently as the 1950s. In this regard, it does not differ dramatically from conventional wealth management which is young compared to the conventional banking. As a point to note, it was only 1955, when Harry Markowitz published his Modern Portfolio Theory, stressing the need for moderation and diversification among investments setting the stage for wealth management as it is known today.

As another point, the emergence and categorization of the 'mass affluent client' as a market segment came into full force in the 1990s, spurring the beginning of wealth management as a sector separate from traditional private banking targeting only the high net worth clients.

The global financial crisis has provided an opportunity to demonstrate how Islamic finance, including wealth management, can benefit both Muslims and non-Muslims alike. Good governance and prudent risk management are inherent to Islamic finance and are two factors that have allowed the industry some protection from the worst of the crisis. However, this is not to say that the industry has by-passed the volatility of the past 3 years. This troubled economic period has highlighted an over-dependence on real estate and private equity among Islamic institutions and investors. Possible explanations for this are the underdevelopment of the Islamic wealth management industry, limited diversified investment products and failures in Islamic distribution channels.

As Islamic wealth management is less developed, there are still large sections of the Muslim investing public who have no exposure to Islamic funds. Whilst the Islamic asset management industry is working to develop a wider scope of products to allow Islamic investors comparable and diverse investment options, wealth management has the responsibility of opening doors to potential investors for these product manufacturers, by expanding their distribution channels and offering new avenues to raise AUM. This includes moving outside the traditional markets of the GCC and Malaysia for new customers and looking to other Muslim markets, as well as tapping the growing Muslim communities in the Western world.

8.4 Opportunity and market size

One of the challenges in analyzing both the current and potential market size is the difficulty in obtaining accurate data. Market size data is often inconsistent. For new market-entrants, this affects how the market opportunity is viewed and how a market entry strategy is formulated, especially distribution strategy.

One facet of quantitative analysis is demographic trends of Muslim countries and growth of number of Muslims. The numbers are large and rapidly increasing with over 1.5 billion Muslims worldwide. Additionally, the demographics of Muslim countries are heavily towards the under-40 age group, especially in the GCC. This would suggest that what underpins the growth expectations of the Islamic asset management industry is a booming younger Muslim generation of potential investors.

It is fair to say that the increasing wealth and education levels of the Muslim mass affluent sector validate an assumption that this sector offers the strongest growth potential for uptake of Islamic products. Hence, means of attracting this sector are an important consideration for distributors when formulating a strategy of maximum reach. Distribution strategy must also focus on attracting high and ultra high net worth clients and family offices who although generally considered to be less focused on Shari'a-compliant investments, will appreciate and consider Islamic products if the asset management industry continues to build suitable product and maintain performance.

8.5 Current Islamic distribution environment

Whereas the foundation of the conventional asset management industry has been the institutional investor followed by the high net worth investor, Islamic asset management focuses on retail investors as institutional investors of the Muslim world. Hitherto, there has been a slow adoption of Islamic funds.

The current situation of Islamic funds distribution to this market has been through asset managers' in-house channels. The most common example seen today is in retail banks, where the asset management arm manufactures funds and the retail arm distributes them.

Few Islamic banks have moved towards open architecture platforms and the trend has been to focus on sales of proprietary funds. To date there are very few Islamic banks in any part of the world that have successfully created a third party distribution culture in their retail or private banks.

Where successful third party distribution has been seen on a broad scale is through regional operations of large international banks. It is relevant to note that Islamic funds need not be confined to Islamic platforms or to Muslim investors only. Both the product and the client base are far broader than that. Along with Muslims in the mostly Muslim majority OIC countries, successful distribution must target the non-Muslim majority segment in OECD countries by re-positioning and re-branding Islamic products as compatible with SRI and ethical investment frameworks.

Conventional banks are also proven, capable and efficient possible avenues for Islamic product sales. The large global retail banks as well as specialized private banks have raised trillions of dollars for global asset managers, and Islamic products can be added to their vast product lineups. Increasing cooperation between Islamic retail banks and large conventional fund managers' thorough Islamic white label offerings will also enhance distribution reach as there will be added incentive to raise the AUM of these funds.

In addition to bank channels, another open architecture distribution opportunity is takaful. Takaful companies represent two opportunities for Islamic asset management – Firstly, the takaful funds where all the contributions are pooled and secondly the unit linked life insurance and savings schemes. Related untapped distribution channels include group life plans and defined contribution plans in both corporate and government pension sponsored plans.

Distribution platforms are another key opportunity. These platforms offer execution, custody and reporting options along with access to a vast number of mutual funds. Global distribution platforms have been a dominant force for conventional distribution and are especially useful for banks looking to implement open architecture. To emphasize the importance of this channel, the assets under intermediation (AUI) of one of the top 10 of these platforms is larger than the entire Islamic asset management industry. For a Islamic asset manager, these platforms offer a vast opportunity to increase access to their funds. Multi-manager Shari'a-compliant funds embedding both in-house and third party funds are another potentially significant channel to raise assets into Islamic funds. Islamic brokerage firms and independent financial advisories are still very much longer-term industry developments. Structured Shari'a-compliant product platforms are another avenue that has been explored lightly. Whereas direct fund sales have not been as successful as hoped, capital protected products have surpassed expectations and represent an important source of retail AUM gathering.

Finally, as in the conventional asset management world, a segment worth influencing is investment consultants who advise institutional investors. As the number of institutional investors looking towards Islamic products increases, the recommendations of these consultants will become vital in decision making.

8.6 Considerations for growth and development of Islamic distribution

Fund domicile and cross boarder distribution

Given that the growth of the Islamic funds industry is dependent on successful distribution channels, the future of distribution is key to the industry as a whole. The progress of the distribution industry requires further targeted development of sales channels as well as understanding the regulatory framework and investor concerns of the geographies and markets that are being targeted.

Understanding the idiosyncrasies of different geographies and markets is vital, as sales and distribution strategies that work in one geography, might not be suitable for another. In terms of the international market, the biggest hindrance for most Middle Eastern asset managers is the regulation, administration and custodial set-up of their products. Although many funds in the region are well-managed with encouraging track-records and a focus on sectors of international interest (e.g. Saudi Equities or GCC Sukuk), operationally they fail to pass cross-border distribution requirements that are standard to international markets and organizations. There are examples of institutions, which have acknowledged the domicile issue as a barrier to further growth and are endeavoring to set up acceptable cross-border product by launching UCITS structures, which have become the global standard for investment funds.

Shari'a-compliance

Another challenge that can pose restrictions for cross-border distribution of Islamic funds is differing understandings of acceptable Shari'a-compliance standards. A strong point of discussion within the industry has been around the unification in Shari'a standards, although even with organizations like AAOIFI in Bahrain and the IFSB in Malaysia, as yet there is no unifying body for Islamic jurisprudence. Whilst the basis of compliance criteria are generally shared – such as low debt-to-equity ratios, avoidance of unacceptable industries - there are situations where interpretations can differ slightly making a fund that might be compliant to one Shari'a board, non-compliant to another. One example of this is Islamic cash management products, for which there are several established and accepted means of implementation in Malaysia, but generally only one acceptable implementation in Saudi Arabia.

The discussion on Shari'a-compliance is a separate and multifaceted discussion. For the purposes of this chapter the relevant points to note are that, like fund domicile and regulatory status, Shari'a standards and Shari'a boards are also aspects for consideration in the development of strategic distribution plans.

8.7 Other supporting factors for a successful distribution industry

Increase investor education and awareness

Education and awareness of the investing public is inherent to the success of the Islamic asset management industry and vital in any discussion around growing Islamic product distribution channels. Post credit-crisis, the wealth management industry continues working to address the issue of regaining investor trust and confidence. Islamic investing offers many advantages highlighted by the credit-crisis and these messages should serve to erase skepticism and apathy of potential Islamic investors. The global financial crisis has highlighted that good governance and prudent risk management inherent to Islamic investing can benefit both Muslim and non-Muslim investors alike.

Whilst the issue of a comprehensive and integrated regulatory and Shari'a-compliant framework to provide investor protection and industry standardisation is not discussed in full in this paper, it is also a vital development for strengthening investors trust in the Islamic finance industry.

Two broad groupings of the Islamic investing public exist with differing educational requirements. The first being investors previously partaking in conventional investing. This demographic has previously invested in conventional products for either reasons of availability or performance. For those investors who are Muslim, but have a lower Shari'a sensitivity or are less pre-occupied with religious compliant investment portfolios, education around the benefits of Islamic investing and highlighting it as a diversification tool or separate asset class for both Muslims and non-Muslims alike is key.

The second demographic is first-time investors. First-time investors whether Muslim or non-Muslim, require a level of education before partaking in any investments. There is also the category of inactive Islamic investors who have felt that their expectation of Shari'a-compliance have not been met by existing offerings. Distributors must be able to fulfil the role of educator and instill a level of trust to attract these investors and potentially promote a formal savings culture to new investors.

The Islamic finance industry itself should also continue to improve its own education and awareness. The debate around standardisation and development of globally accepted guidelines is one example of this. It is important that the Islamic wealth management industry is not content with acting primarily as a "deposit-taking" institution and mutual funds and wealth management products are used to make Islamic wealth management mainstream within Islamic banks. What is also vital is that these funds and products follow a natural path of evolution. For example, plain-vanilla mutual funds should be understood, accepted and offered via competent distribution channels before these channels launch into promoting 'innovative' and advanced portfolio strategies such as absolute return, structured products and hedge funds. Whilst the availability of a wide range of sophisticated products offers greater ability to construct diversified asset class portfolios, the danger exists that the industry is running before it can competently walk.

8.8 Government support and public policy

In the western world, growth in AUM in the conventional asset management industry is facilitated and encouraged by government and public policies. For example, the pension fund market is stringently regulated in these countries and it is the policy of governments to encourage and reward their citizens and institutions to invest into mutual funds by continued education on the benefits of savings and offering, such as tax incentives.

In Muslim countries, government and public policy does not drive the Islamic mutual funds industry in a similar manner. Little has been done to encourage the development of voluntary or occupational schemes. For example, all the pension funds in the GCC are state run. These government run entities make the investment decisions on behalf of the contributors, but generally do not invest in Islamic products. There are few private sector employee-controlled pension, superannuation or retirement plans and no tax benefits of investing in a Shari'a-compliant mutual fund portfolio. The west also has state funds but a plethora of others have been allowed to operate, and have proved to be major contributors to the AUM of conventional mutual funds.

Government support and public policy can play an important role in supporting and encouraging the growth of Islamic asset management. Government encouragement of pension plans and collective saving schemes, creating clear standards for Shari'a-compliant alternatives to conventional investing and banking, facilitating the operations of Islamic institutions and eliminating any distortions to competition are important policy tools that, among others, can help the industry grow in the direction it needs to.

8.9 Conclusion

This chapter has explored the subject of distribution of Islamic funds, outlining some existing trends and challenges for the industry. To date, distribution has primarily been via direct retail banking networks. These networks have been the only successful distribution implementation however they have focused on proprietary products and few have moved towards open-architecture models. The need for evolution in both open-architecture and third-party distribution channels to allow for expanded product penetration is paramount to the growth of the industry. With the size of the Islamic asset management industry estimated to be between USD 360 billion to 480 billion, the approximately USD 50 billion in AUM today is a small fraction of that potential. Leading Islamic asset managers have to break from the in-house retail network based model and adopt the distribution model of the successful conventional asset management firms to reach this estimated size.

Considerations for growth of the industry should focus on expanding the geographical and product positioning from a handful of Muslim nations to the greater OIC as well as the OECD countries. The similarities of Islamic products with SRI and ethical asset management products will open up a far greater target market than what exists today. Importantly, the global financial crisis has highlighted that good governance and prudent risk management inherent to Islamic investing can benefit both Muslims and non-Muslims investors alike. Unless Islamic asset managers take concrete steps to establish funds which can be sold easily across multiple jurisdictions extending beyond Arab regions, the growth of the industry will remain challenged. It is imperative that the 60 or so Islamic funds already established in Europe, a handful of which are UCITS, be expanded upon and then strategically passported to wealth management centres and made available through the right distribution channels.

There are several avenues to be explored as distribution channels, including Islamic and conventional banks, insurance and takaful platforms, fund supermarkets, fund of fund managers, multi-managers, structured product providers and platforms, independent financial advisors and consultants. Fund domicile and varying acceptance in Shari'a-compliance pose some challenges to global expansion; however it is encouraging to see examples among the GCC asset managers who are working to address this. Increasing awareness and education, as well as shifts in policy and support from institutional investors will also help drive the success of the Islamic fund industry. Without widespread channels for the sale of funds, the industry will struggle to achieve its full potential. If distribution strategies are not successful in attracting AUM, the concern is that asset managers will begin to pull back from Islamic fund development.

As a final thought, the Islamic asset and wealth management industry is in its infancy and distribution channels are similarly in the nascent stages, with much room for development and growth. Islamic bank assets are expected to reach USD 2 trillion by 2015, and Islamic-investment products potentially have an important role in fostering the development of financial services and a savings and investment culture in many majority-Muslim countries. There are challenges, and the anticipated growth has not been seen to date, but Muslims around the world are demonstrating an increasing interest in investing according to their religion and increasing wealth and education levels of the Muslim mass affluent sector will drive the growth in funds. Shari'a-compliant products potentially have an important role in fostering the development of financial services and a savings/investment culture. Once distribution channels are focused and efficient, and the product universe is diverse and acceptable in all markets, there is no reason why we should not see substantial growth in the Islamic asset management industry. It is a massive opportunity to be tapped with a natural market looking for direction.