SHARI'A IN

THERE ARE 10,000 MUSLIM MILLIONAIRES IN BRITAIN, SAYS **STEPHEN SPURDON**. BUT THEIR NEEDS HAVE BEEN MET RATHER PATCHILY. UNTIL NOW, THAT IS

It seems a little surprising that Shari'a-compliant investment should have started in the UK only as recently as the 1980s, when the first UK Islamic bank was launched. But then, the growth of the Islamic investment market.

These days we're seeing seen a steady number of Shari'a-compliant offshore fund launches from UK based managers; the launch in 2008 of an Islamic insurance company and a pre-paid MasterCard (no interest, to keep it halal); a new Islamic index in London; and this year's launch of a Sukuk bond (the Shari'a-compliant equivalent of fixed interest corporate bonds). All of these things have helped to place the UK at the forefront of Muslim investment.

Well, that's the theory. But in practice, offshore centres in Europe have also been moving quickly to snaffle their share of a global Shari'a-compliant investment business that *The Economist* magazine estimates at $820 billion. It's probably an advance on the days when UK Muslims sent most of their savings to Pakistan or Bahrain, but there's still work to do.

Careful With Those Stereotypes

But how is the UK influenced by developments in the global Shari'a-compliant investments scene? Let's start by getting a few misconceptions and confusions out of the way.

VESTMENT

For a start, it's a mistake to assume that all Muslims have the same priorities or the same needs, and by no means all insist on Shari'a compliance in financial matters. Communities from Bangladesh or Indonesia may see the world quite differently from Arabs or Iranians. And while some national governments, including Pakistan, insist on full Shari'a finance, others such as Bahrain or Dubai may adopt a less stringent approach.

The estimable (and sometimes fallible) Wikipedia has a useful checklist of Shari'a practices at ***http://tinyurl.com/mm8drfn***. Well worth a look.

"It is important to remember that there is a distinction between Arab and Islamic," echoes Dr Mehmet Asutay, Director of Durham Centre for Islamic Economics and Finance at Durham Business School. "Not all Arab finance is Shari'a-compliant."

Asutay says, for instance, that some parts of the Arab world are now placing a strong and increasing emphasis on investment in small and medium enterprises (SMEs) and start-ups. "The drive to provide capital for start-up businesses goes back to the Arab spring," he says, "where a lot of the dissatisfaction over high levels of unemployment meant that people took to the streets." But for others, start-up investment is still something that's kept within the family.

Crowdfunding, Asutay says, is becoming increasingly acceptable in the Arab world as a key means to raise capital for start-ups. And yes, that does raise a few questions for Shari'a investors, because of the forms that many crowdfunding vehicles assume. At present there is still no Shari'a-compliant crowdfunding platform in existence, although one is believed to be in development.

No Leverage

Dr Asutay adds that, while Shari'a-compliant investment is growing, the fact that it spurns financialization (leverage of assets) means it may be more robust but that it lacks the pace of modern investment. He adds, "There is little demand [for leveraged investments] in the Middle Eastern centres, because the economies there are so oil-based. But there has been significant investment in real estate - and that can also be seen in London, for instance, where there is substantial Muslim investment in real estate in prime areas."

Priya Oberoi, managing partner at Oberoi Capital Partners, has deep experience in Shari'a-compliant investment - having previously worked as the head of Islamic derivatives and structured products at a major City law firm in multi –jurisdictions.

She agrees that the market in Shari'a-compliant investment had a lull, post-Lehman, but she says that since January things have been picking up considerably. While the Sukuk bond market did not collapse, she says that returns of around 4% left investors wanting more. "There is a lot of Shari'a money out there that is completely untapped," she says. "It's lying around in cash accounts. But conventional products cannot access that money."

How Much Debt Is Too Much?

Seeking to advise some of that money is Simply Sharia – which claims to be the only FCA-recognised financial adviser in the UK that is dedicated to the provision of Shari'a-compliant advisory services. Founder and CEO Faizal Karbani recognises the difficulties involved in adapting what is available to meet the demands of Shari'a.

"There are few companies that have no involvement in interest - which is not allowed under Shari'a, of course" he says. "As such, Shari'a-compliant investment is very much a work in progress, and scholars have had to arrive at an understanding whereby a certain ratio of impurity is tolerated. According to their understanding of scripture, companies with up to one third of the capital financed by debt are acceptable."

Ten Thousand Millionaires

Economies of scale can be a problem for Shari'a-compliant investment. For one thing, the market-place is relatively small, with a UK Muslim population of only about 2.7 million, out of a UK total of 65 million. And for another there's the fact that, having a youthful profile, the Muslim community tends to have a lower than average wealth level. But the Muslim Council of Britain estimates there are 10,000 Muslim millionaires and a growing professional class which is more likely to opt for Shari'a-compliant investment as their disposable income gives them that choice.

At present, however, we'd have to say that the obstacles are still there. One problem so far has been the extra layer of fund management cost that results from the need for the essential Shari'a Advisory Board – a factor which Karbani believes will diminish proportionately as the products gain scale.

More concerning, perhaps, is the gap in knowledge amongst the scholars themselves, who might be expert in Shari'a but who still need to equip themselves with a knowledge of the financial system, and to apply it to their understanding of modern finance.

"The reason there are so few Shari'a-compliant products on the market," says Oberoi, "is because so few people have the skillset of understanding both conventional and Shari'a products." There may be only 10 to 15 true experts in the world, she suggests. But Karbani is more reassuring on this point. "This problem has been recognised,", he says, "and the IFC (Islamic Financial Council UK) now has programmes available for scholars to learn about the financial system."

Onshore, Offshore

Another problem is the relative anonymity of Shari'a-compliant funds, because they are largely domiciled offshore. This, coupled with problems that UK advisers may have in terms of how to define the investments, tends to depress demand.

The Bank of London and the Middle East (BLME) addresses some of these important issues in a study of adviser attitudes, entitled 'Are Advisers Open to Alternative Investments?' The report, which is obtainable from ***http://tinyurl.com/mkjnxnn***, concludes that:

"Compartmentalising new products helps advisers sift through them in a disciplined fashion and therefore, uncertainty around how to classify a certain product or product type could be mean that it is overlooked in favour of something more familiar.

"A considerable portion of advisers are unsure of whether Islamic products are alternative investments or not. The fact that almost 40% say they are not sure of their answer to this question indicates the level uncertainty over how Islamic products fit into their existing asset allocation models. One can argue that until advisers decide how they are to classify Islamic investments, they will be less keen to recommend these products to their clients."

It gets more daunting. Even if there were any such investments domiciled in the UK, neither the Association of Investment Companies (AIC) nor the Investment Management Association (IMA) have no plans at present to categorise them. A search amongst fund data aggregators proves to be more fruitful, however, as all of these include offshore fund sectors.

Where To Find Them

However, even here, Shari'a-compliant funds are placed in sectors with other types of funds that cover the same subject areas. This means, in effect, that assessing the case for a more robust nature for Shari'a-compliant investment is more difficult than it might be. Fortunately, Morningstar flags all Shari'a compliant funds, meaning that we can conduct a search for a data set. Tellingly, we find that only 19 out of the 483 funds listed are domiciled in the UK.

They include SWIP's Islamic Global Equity Fund (now part of Aberdeen Asset Management), which was launched as a Luxembourg domiciled sicav in 2005. Or a handful of trackers and ETFs from dbx and iShares. *(See below.)* Not forgetting the Children's Mutual, which launched a Shari'a baby bond for child trust funds in the same year. Details from ***http://tinyurl.com/mksvtez***

Look abroad, and the range of available funds increases significantly. BNP Paribas runs a series of funds from Luxembourg; CIMB operates a sizeable range from Dublin; and dbx, unsurprisingly, from Frankfurt. Advisors will need to satisfy themselves that these funds do indeed meet Shari'a conditions – it might not always be enough to assume that a fund made up of 'Islamic World Titans', or whatever, will necessarily meet religious criteria

Property Funds

A good reason for looking at offshore funds is to gain access to assets that may be unavailable onshore. Such as the residential property funds from London Central Portfolio. It has launched four closed-ended Jersey domiciled funds - two of which, London Central Apartments (LCA) I and II are Shari'a-complaint.

LCP chief executive Naomi Heaton says that the new fund's portfolio includes rental properties in postcodes surrounding Hyde Park. Heaton adds that, while there are obvious tax advantages of domiciling in Jersey, "property investment companies as funds cannot be done in the UK. They are not FCA recognised, as the FCA does not regulate property investment companies." *[Editor's note: the FCA has certain powers to launch legal actions if it thinks property portfolios are being used as pseudo-banks.]*

And Back to ETFs

Of course, anywhere in the world that you find an index, there's likely to be an ETF. Since December 2007 iShares has run two Shari'a-compliant ETFs in London, although domiciled in Ireland - tracking the MSCI World Islamic and Emerging Markets Islamic indices.

Both of these funds cost more than their non-Islamic equivalents. The World Islamic ETF has a TER of 0.60%, against 0.50% for the World ETF's TER, and the Emerging

Markets Islamic ETF TER is 0.85% against 0.75% for the Emerging Markets ETF. It appears that the difference is down to the fact that that one set of funds has a Shari'a Advisory Board and the other set does not.

To those investors who require Shari'a compliance, this is likely to be a price they are prepared to pay. As an adviser, you will be more interested in whether the purportedly better performance of sharia-compliant investments during the downturn has compensated for the extra charge.

Sadly, comparing the performance of the underlying MSCI indices suggests that is not the case. The World Islamic beat the World by 5.90% to 4.63% over the 10 years to 18 April 2014, but lost out over five and three years with 12.87% to 13.65%, and 6.48% to 8.25%, respectively. There are many reasons why this might have happened, but one of the key possibilities is that Shari'a funds tend to be more heavily committed to technology than their counterparts elsewhere, and it's been a tough decade for these firms. (Conversely, of course, Islamic investors avoid western banks, which have had a torrid time. You win some, you lose some.)

What's New in the UK?

Last October the Prime Minister surprised the World Islamic Investment Forum by announcing the creation of a new Islamic index on the London Stock Exchange.

"I don't just want London to be a great capital of Islamic finance in the Western world," he said. "I want London to stand alongside Dubai as one of the great capitals of Islamic finance anywhere in the world"

Accordingly, this year sees the release of an Islamic government bond - called a sukuk - worth £200 million, which is being structured so as to bring in a fixed return from a tangible asset or service, rather than paying interest. This will keep it in line with Islamic financial principles.

There's a Shari'a NEST fund, which invests in the HSBC Life Amanah Pension Fund, and which mirrors the Dow Jones Islamic Titans 100 index. Details from ***http://tinyurl.com/mzcgzsg***

Synthetic Replication?

Given the Shari'a insistence on real assets, you might suppose that physical replication ETFs would be the only option. But in practice this not is the case. For instance, db X-trackers' three Shari'a-compliant ETFs that track S&P Islamic indices are all synthetic - using swaps to replicate the underlying indices. The difference is that, instead of using a standard swap, they use 'Wa'd' agreements - Shari'a-compliant contracts.

Interestingly, there are differences between the Islamic indices that are tracked. With the FTSE Islamic indices, weapons manufacturers are deemed non-compliant; however, the Shari'a Board for S&P Shari'a Indices deems that weapons for self-defence are halal. As Nick Sudbury notes in this month's Ethical Funds feature on page 48, transatlantic opinions will often diverge on what meets ethical criteria and what doesn't.

No Shorts, No Hedges

A final feature to note about Shari'a-compliant investment is that you are not allowed to sell what you do not own - so short-selling is prohibited. That makes hedge funds basically a no-go area for devout Muslims.

It also points up one of the basic attractions of Shari'a-compliant investment – an emphasis on the real. And that, of course, is where the world headed after the credit crunch. Ironic that something 1,400 years old should be ahead of the pack just by standing still, isn't it. IFA

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