

# Case for Islamic Asset Management

## About CIMB-Principal Islamic Asset Management

CIMB-Principal Islamic Asset Management (CIMB-Principal Islamic) acts as a global partner to institutional global investors, providing a range of Islamic investment portfolios to suit differing needs. The joint venture between CIMB Group Sdn. Bhd. and Principal Global Investors allows CIMB-Principal Islamic to leverage on the strong global Islamic credentials of CIMB Group (via CIMB Islamic) while Principal Global Investor's lends its expertise in global asset management.

Headquartered in Kuala Lumpur, Malaysia, CIMB-Principal Islamic is strategically located in the world's first country with a complete Islamic financial system operating in parallel to the conventional banking system. This allows the firm to leverage on Malaysia's comprehensive Islamic financial infrastructure and its adopted global regulatory, legal and Shariah best practices.

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The development of Islamic asset management has been driven by rising demand for Shariah-compliant<sup>1</sup> investments from an estimated population of 1.6 billion<sup>2</sup> Muslims worldwide, approximately 23.4% of the world population. Its relevance as an alternative investment class for all investors, whether Muslim or non-Muslim, has accelerated with the rising importance of business ethics and fiscal conservatism. This paper aims to provide information on the foundations of Islamic investing as well as to describe what clients should consider when evaluating Shariah-compliant asset management firms.

## Understanding Islamic Finance and Asset Management

Islamic asset management is grounded in Islamic finance principles, which express an explicit intention to meet the financial needs of participants with integrity and in a manner that is tangible, fair, trustworthy and honest, while ensuring a more equitable wealth distribution. All Shariah-compliant assets embrace the following key principles:

- Materiality and validity of transactions
- Mutuality of risk sharing
- Investment based on social and moral values

### Materiality and Validity of Transactions

Islamic finance encourages investing in business activities founded on real, productive or trade-related activity and generate fair and legitimate profit. There must be a close link between the financial and productive flows that underpin Islamic finance. This ensures the funds are being invested into real assets and companies, rather than exotic investments, such as conventional derivatives, that are not directly linked to the underlying assets. This has had the effect of insulating the Islamic financial system from risks associated with excessive financial leverage and speculative activities in recent years.

A central feature of the Islamic financial system is the prohibition of the payment and receipt of riba, or interest. Riba refers to an increase or excess that accrues to the owner in an exchange or sale of a commodity, or by virtue of a loan arrangement, without providing any equivalent value to the other party. Money in Islam is not a commodity. The prohibition of interest arises from the fact money is perceived only as a medium of exchange, a store of value and unit of measurement. It possesses no intrinsic value.

As such, Islamic bonds, or sukuk, do not pay interest like conventional bonds, but pay coupons in a different manner such as rent, profit, etc. Sukuk are trust certificates or participation securities that grant investors a share of an asset along with the cash flow or profit and risks commensurate with such ownership. This differs from conventional bonds, which are based on the exchange of paper for money with interest imposed to measure returns and liabilities.

This is also the essence of the principle of no profit sharing without risk sharing (al-ghunm bi-'l-ghurm). That is to say, the earning of profit is legitimized only by engaging in an economic venture that contributes to the economy.

### Mutuality of Risk Sharing

The principle of fairness is also reflected in the risk- and profit-sharing characteristics of Islamic financial transactions. This requirement must be clearly defined at the onset and serves as an additional built-in mechanism that promotes the adoption of sound risk management practices by financial institutions engaged in Islamic finance. The exercise of appropriate due diligence and higher standards of disclosure and transparency must be observed by financial institutions, which in turn enforces market discipline and minimises informational asymmetries.

<sup>1</sup>In a manner that is consistent with Islamic law and beliefs

<sup>2</sup>The Pew Forum on Religion & Public Life, Jan. 2011

In Islamic finance, all forms of contracts and transactions must be free from gharar, or uncertainty. Terms and conditions—the roles of the parties, payments to be made, dates, quantity and quality of goods to be exchanged, etc.—must be honestly and clearly laid out. Ambiguity or uncertainty in contracts could lead to interpretational differences that may provide an advantage to one party over another. To avoid potential conflicts in the future, this must not be present in Islamic financial transactions.

### Investment Based on Social and Moral Values

While the principles of Islamic finance are explicitly defined in Islamic law, the net effect is ethical business activities and practices. Similar to socially responsible investing, Shariah-compliant investment filters out businesses engaging in activities deemed unacceptable, such as alcohol, tobacco, pornography, gambling, armaments, etc. Islamic asset management is a social and moral values-based investment alternative that is, for the most part, congruent to a conventional values-based investment approach that mandates social values and good governance.

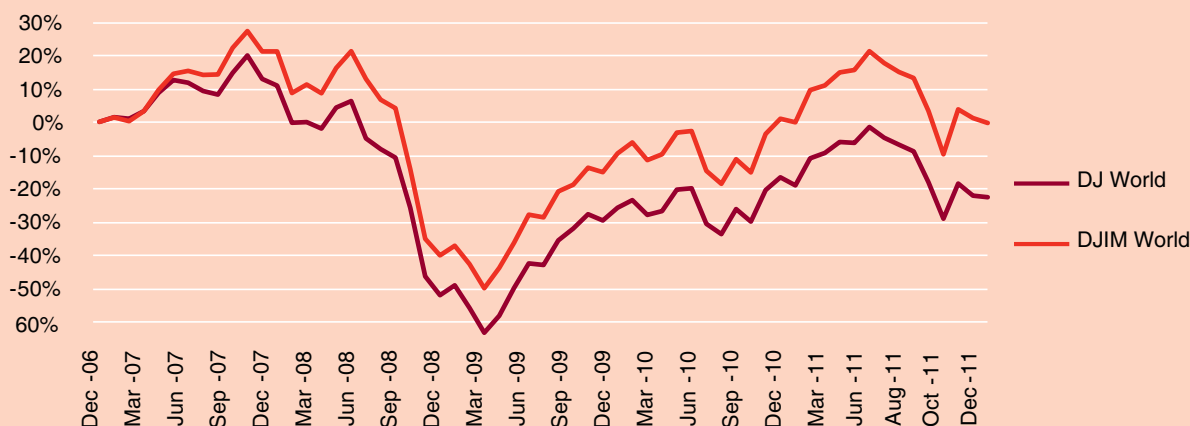
## Benefits of Islamic Asset Management

The Shariah-compliant investment industry is still developing, but growing very rapidly. In fact, it is one of the fastest-growing sectors within the worldwide financial system. The global Islamic fund management industry expanded by 7.6% in 2010, reaching US\$58 billion<sup>3</sup> in Shariah-compliant assets under management globally. Shariah-compliant investing is not just for investors of the Islamic faith. Investors of all stripes are drawn to such values-based investing. Likewise, investments are not limited to Islamic companies, but any company that engages in acceptable activities. Besides the socially-responsible motivation, reasons for non-Islamic investors to invest according to Shariah principles include:

- Comparable returns to conventional investments over longer periods (five to 10 years), although they may outperform or underperform conventional investments over shorter periods, as can be seen in Exhibit 1 below. In fact, over the last five years the Dow Jones Islamic Market World Index (DJIM World) outperformed the Dow Jones World Index (DJ World) by an average of 3.74% per year, returning -0.25% compared with -17.57%. The same can be said for the period between October 2007 and March 2009, the worst bear market in decades, when the DJIM World reported -43.21% compared to -50.48% for the DJ World (Exhibit 2).

### Exhibit 1: Five-Year Cumulative Index Returns\*

DJ World vs. DJIM World (December 2006 – December 2011)



Source: Bloomberg

\*Returns are for price levels of the Dow Jones indexes only and do not include dividend reinvestments

### Exhibit 2: Comparative Returns\* and Volatility

18-month bear market (October 2007 – March 2009)

Five years (January 2007 – December 2011)

	DJ World	DJIM World	Difference
Total Return	-50.48%	-43.21%	7.27%
Annualized Total Return	-37.87%	-31.83%	6.04%
Annualized Volatility	34.08%	32.47%	-1.62%

	DJ World	DJIM World	Difference
Total Return	-17.57%	-0.25%	17.32%
Annualized Total Return	-3.79%	-0.05%	3.74%
Annualized Volatility	21.83%	20.63%	-1.20%

<sup>3</sup>5th annual Ernst & Young Islamic Funds & Investment Report (IFIR 2011)

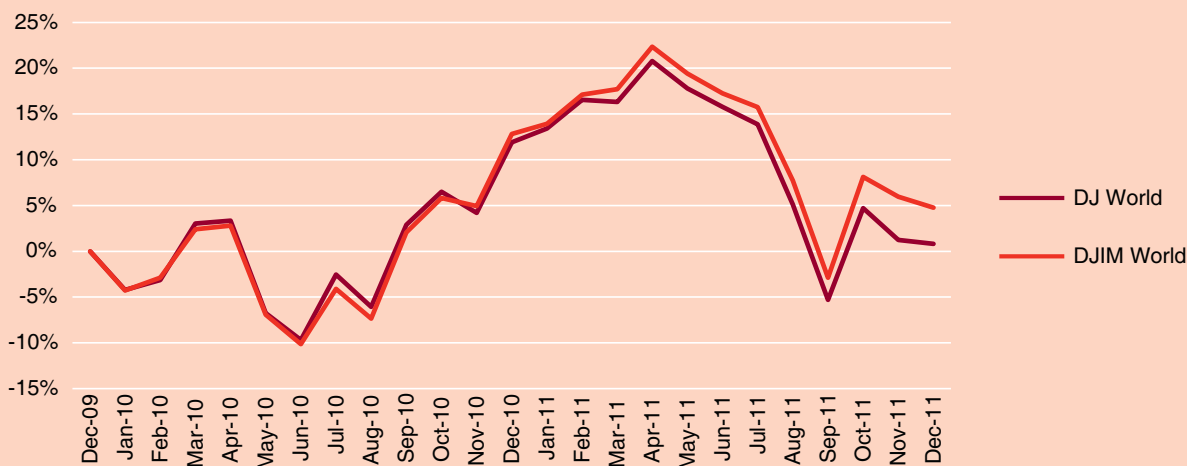
Source: Bloomberg

\*Returns are for price levels of the Dow Jones indexes only and do not include dividend reinvestments

- **Greater stability of returns** – Shariah-compliant equities are less volatile than their conventional counterparts, both in times of crisis as well as in times of stability. One reason for this is because excessive financial leverage is prohibited. This can be seen by comparing the volatility of the DJIM World with that of the DJ World, as illustrated in Exhibit 2 on the previous page.
- **Embedded risk management** – To be considered Shariah-compliant, equities must pass a rigorous screening process, which ascertains, among other things, whether the underlying companies are sufficiently capitalized to weather difficult times and liquid enough to meet short term obligations. This process sets strict limits for various financial ratios, such as debt to total market capitalization or debt to total assets to limit leverage, and cash to market capitalization or cash to total assets to ensure sufficient liquidity and productive use of cash. Because of such rigorous screening, the underlying companies were better capitalized and more liquid than many of their conventional peers. Therefore, they were less exposed to the deleveraging, extreme solvency, liquidity concerns and the consequent sharp price declines experienced by these peers during the global financial crisis.
- **Bonds backed by real assets** – Sukuk (Islamic bonds) are asset-based or asset-backed, where there is an asset (or pool of assets) underlying every transaction and the ownership of that asset or pool is transferred to investors. Thus investors enjoy all rights and obligations that accompany ownership. In asset-backed structures sukuk holders have recourse to the underlying assets.
- **Greater transparency** – Since transactions and contracts must be free of uncertainty, and terms and conditions clearly defined at the outset, Shariah-compliant investments may produce more predictable results.
- **Diversification** – While they are highly correlated, Shariah-compliant investments limit the downside slightly better than conventional investments do. As shown in Exhibit 2 on the previous page and Exhibit 3 below, during the recent bear market, Islamic funds fared better period than conventional portfolios did, declining less, experiencing lower volatility and recovering nearly as much ground lost as the markets have recovered.

### Exhibit 3: Two-Year Cumulative Index Returns\*

DJ World vs. DJIM World (December 2009 – December 2011)



Source: Bloomberg

\*Returns are for price levels of the Dow Jones indexes only and do not include dividend reinvestments

## Holistic Islamic Asset Management

The popular definition of Islamic asset management deems that an investment manager is mandated to invest only in Shariah-compliant securities. CIMB-Principal Islamic advocates for a much broader definition of Shariah-compliant, going beyond the investment screening process to ensure that all aspects of the investment management operations are Shariah-compliant.

### Islamic Investment Screening Process

Islamic equities are screened at the operational level to ensure the business qualifies as Shariah-compliant. Broadly, screening is based on industry type, financial ratios and tolerable benchmarks.

Islamic bonds (sukuk) are determined to be Shariah-compliant predominantly based on their financing structure. As mentioned earlier, Sukuk grant investors a share of the underlying asset, along with the associated profit and risks, rather than paying interest, like conventional bonds. Additionally, proceeds from sukuk issuance must be used in a Shariah-compliant manner.

### Value-Added Optimisation of Islamic Portfolios

In addition to optimizing the portfolio based on the qualified Islamic equity and sukuk investment universe, the investment manager may add further value by being able to:

- Evaluate whether major market changes are due to Shariah concerns, market concerns, or perhaps both
- Evaluate whether pricing differentiation between conventional and Shariah securities are due to Shariah differences, market dynamics or imbalances, regulatory requirements, or government initiatives
- Advise clients on potential benchmarks for their portfolios
- Identify risks peculiar to Islamic securities and markets and mitigate them effectively
- Optimise a client's portfolio by anticipating market trends that could affect the securities universe, and
- Understand a client's Islamic needs and then structure an optimal asset allocation based on the above abilities.

These capabilities coupled with a disciplined investment process should yield sustainable investment returns over the longer term.

### Investment Management Operations

Holistic Islamic investment management services extend to the structure and operations of the investment manager. The Securities Commission of Malaysia, the world's first country to have a full-fledged Islamic capital market operating in parallel to the conventional banking system, has mandated the following requirements:

- Shariah adviser appointed at company level
- Shariah adviser appointed at fund level, if offering retail products
- Designated Shariah compliance officer to report any Shariah non-compliance directly to the Shariah adviser and board of directors for consideration and / or immediate remedial action
- Fund management organization with adequate knowledge of Islamic fund management

These guidelines may vary from country to country but are viewed to be a benchmark within the industry.

Finally, the investment manager must have processes in place to handle investment securities that may turn "non-compliant" due to various reasons. This is called the "purification process."

In Malaysia, there is a clear guideline on the "purification process." In some countries, the purification may even be done at dividend level, where the "non-Shariah" portion is purified by divesting it to charity.

### Islamic Advisory

One of the key success factors of Islamic asset management is the investment manager's appointed Shariah adviser. The Shariah adviser must have a robust and institutionalized advisory process in place to enhance the integrity of its Shariah decisions. To ensure its Shariah interpretations are practicable, its people must have traditional capital markets, investment and product development experience. They must also be familiar with the differences in Shariah interpretation by jurisdiction. Finally, to promote universal acceptability of its decisions across regions, the Shariah adviser must ensure its Islamic scholars are of diverse backgrounds and come from various jurisdictions.

## Conclusion

Shariah-compliant investing is growing rapidly as an alternative investment class for all investors, both Muslim and non-Muslim, for its foundation in ethical business practices, social responsibility and fiscal conservatism. While Islamic clients may be mandated to invest only in a Shariah-compliant manner, other investors do so for the benefits they derive, including greater stability of returns, transparency and diversification.

For clients who value or are mandated to operate within Shariah law, it is important to have a trusted investment management partner experienced in both investment management and Shariah principles. With its established track record of managing Islamic portfolios and its strategic location in a key Islamic investment hub, CIMB-Principal Islamic is a natural choice.

All figures shown in this document are in U.S. dollars unless otherwise noted. The information in this document has been derived from sources believed to be accurate as of March 2012. This document is provided to you for information only and should not be construed as an offer or a solicitation of an offer to purchase or subscribe or sell securities. It may not be reproduced, distributed or published by any recipient for any other purpose. The information contained herein has been derived from sources believed to be reliable and is current as at the publication date. No representation or warranty is made nor is there acceptance of any responsibility or liability as to its accuracy, completeness or correctness. Expressions of opinion contained herein are those entirely of CIMB-Principal Islamic Asset Management Sdn Bhd only and are subject to change without notice. Persons wishing to rely upon this information should perform their own independent evaluation of risks and benefits or consult directly with the source of information or obtain professional advice.

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