Prospects and Players

Islam & Hedge Funds

By Michael Saleh Gassner

Hedge funds have received much publicity in recent years due to their influence in conventional capital markets. Their total volume exceeds that of the Islamic finance industry altogether, with more than $1,000 billion in assets under management, including debts, while Islamic finance is estimated to be at about $250 billion to $500 billion.

What is a conventional hedge fund? It lacks a clear definition, but is basically a private investment vehicle for high net worth investors and institutional investors. It is typically privately placed and not subject to the regulation of a public mutual fund. The strategic aim of a hedge fund is to actively manage a portfolio of assets, mostly listed stocks. Often the goal is an absolute return strategy, to earn profits independent of whether the market goes up or down.

Hedging or Trading?

Let´s illustrate this strategy with an example independent of the stock markets. A wholesale trader of spices is expecting a price increase in pepper, but a decline in the price of cardamom. He may react in either of two ways:

1. Buying more pepper to gain an advantage and reducing his stocks of cardamom to a minimum ("long only")
2. Buying pepper and selling cardamom with future delivery (Islamic term: "Salam," conventional term: "short") against full payment today.

The wholesale trader shows what is called a bullish view on pepper and a bearish view on cardamom. If he is buying the same value of pepper as he is selling in cardamom, then his position would be called market neutral in regard to the general trend of the spice market. If the general trend goes up, he wins on the pepper; if the market goes down, he wins on the cardamom but loses on pepper.

The investment strategy of the wholesale trader of spices is similar to the popular long/short equity strategy chosen by many of the hedge funds. Unlike the trader in the example, hedge fund managers do invest in the stock markets and use a technique called the short sale, which is in fact a forward contract. While Shariah allows a spice trader to act as he does in our example, there is a different view regarding conventional hedge funds. The reasons for this include the lack of social and ethical screening criteria, the method of leveraging and the way hedge funds benefit from the downside of price development.

Shariah Issues

Shariah screening criteria include a number of industry exclusions (alcohol, banking, etc.) and observance of certain financial ratios to identify Riba income and avoid impermissible trading of debts. The criteria are published in the Shariah Standards 2004-5 of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). These criteria can be seen as the technical side of implementation. They are restrictive, but still allow a flexible investment strategy.

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Contrary to some perceptions, leveraging is possible in Shariah; e.g., a mutual stock can be purchased with a deferred payment. This way, the spice trader could have bought his pepper with 10 percent cash and 90 percent against deferred payment, establishing a substantial exposure to leverage.

The most difficult issue to deal with is deriving benefit from falling prices of a given stock. While for commodities such as cardamom, a sale by description for future delivery is permissible, the AAOIFI's Shariah Standard No. 21, 3/11 does not allow the sale of a stock on the basis of future delivery (Salam). Some scholars do hold a minority view in accepting the sale by description of a frequently traded stock on an exchange, which is done by the Al Fanar Fund.

The conventional method of short selling is borrowing a stock and selling it on the market. The short sale is made with the expectation of the price going down, which would allow the investor to purchase the shares at a lower price in order to deliver the securities earlier sold short. This method is not acceptable according to the AAOIFI Standard No. 21, 3/9 and 3/16.

Looking at Alternatives

An alternative is a down payment with revocation option (Arbun). This instrument is known classically in the Hanbali School of Fiqh but is not accepted among the founders of other schools of Islamic thought. Beside the issue of whether part of the payment can be deferred until delivery if the down payment remains with the seller in case of revocation, there is the issue

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The market for Islamic finance, already worth in excess of $230 US Billion, is predicted to maintain growth rates of 10-15% for the next 15-20 years. The poor equities market performance coupled with the repatriation of funds from post 9/11 has led to an explosion in the demand for Islamic fund products. This growth in demand has put the spotlight on issues such as; coping with the international regulatory environment, introducing successful Shariah compliant products and capitalising on the growing Islamic Sukuk market – challenges that must be met if Islamic funds are to survive and thrive.

of ownership of the stocks. The seller is supposed to hold the securities if he accepts the down payment, as is generally required in any type of sales contract. If this is upheld, then Arbun could only work like an American option, letting the buyer benefit from raising prices, but neither side benefiting from falling prices.

However, if a down payment with the revocation option is permitted without the seller being required to own the equities, then other types of benefits from falling prices can apply:

1. Falling prices below the initial (high) down payment force the buyer economically to execute the contract and pay the remaining price in order to minimise his losses, while the seller can buy more cheaply from the market to deliver, hence benefiting from the falling prices.

2. The client accepts a down payment from his prime broker, who in the next step also makes a binding promise to purchase the equities from the client in case of being below the strike price of the down payment.

The first method described is feasible; however, it does not fit into the framework of a prime broker, the party with which the prospective Islamic hedge fund would execute its orders. As a Salam contract, it could be negotiated, but it would not be as competitive an instrument, considering the costs to bear for transactions.

The second method should be considered indicative at this point, as the Arbun method used by some funds is not disclosed to the wider public. It basically aims to replicate the economic effect of a conventional short sale, whereby the client may benefit from falling prices but can lose unlimitedly from rising prices. The actual restrictions imposed by regulation and legal documentation require a huge effort to realise such a concept.

Mohamed Obaidullah in Islamic Financial Services mentions the Bai Al Istijrar concept, which offers wide flexibility, including replication of Asian and barrier options. Basically, it is a framework to enter into several instalment purchases (master Murabaha). However, it has not yet been known to be utilised for the purpose of hedge funds or short-selling replication.

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Pros and Cons

If Shariah compliance is accomplished, the questions of the individual benefit of hedge funds as well as the impact on the wider society need to be revisited. Hedge funds are controversial. While many funds reportedly outperform conventional long-only mutual funds, there has also been a wide range of famous failures, such as LTCM, the Quantum Fund and most recently, Amaranth, with a $6 billion loss.

Burton G. Malkiel and Atanu Saha undertook a major empirical analysis on risk and return of hedge funds with astonishing findings reported in "Hedge Funds: Risk and Return," in Financial Analysts Journal, Volume 61, Number 6, 2005. First of all, they found that the publicly known returns are overstated because of two biases:

1. Only successful hedge funds report data (backfill bias)

2. Only surviving hedge funds remain in the databases (survivorship bias).

Hedge funds' low correlation with long-only equity indices would constitute a meaningful diversification for any stock portfolio; however, the range of individual hedge fund returns is substantial, as is the variety across styles.

These findings suggest only investing if access to the top managers of hedge funds can be assured. Reportedly, those have a 30 percent return on investment over a substantial period of time. However, the example of George Soros shows that even steadily successful funds can suffer if the investment strategy fails: Soros' Quantum Fund was shut down after a long period of success ended abruptly with investments in Russia.

Even more doubts arise considering the findings of Malkiel and Saha claiming that the chance of a well-performing hedge fund performing above average the next year was about 50-50. Historic performance is not necessarily an indication of the future. To identify superior managers and to access them is a true challenge.

Running Risks

Why do such hedge funds achieve such excellent absolute performances as well as such harsh failures at times? The answer lies in their strategies. The application of long/short investments does indeed mitigate market risk, but enlarges manager risk. While a position of 60 percent stocks long and 40 percent stocks short is almost neutral, leverage can help to eliminate market risk further. Using 50 percent debt finance in the transactions, the fund would be 120 percent long and 80 percent short, hence, not significantly being affected from market downturns. If, however, the manager chooses stocks that behave the opposite of expected, then the losses are tremendous, because of the unlimited losses of short positions and leverage.

The critical impact on society comes when a hedge fund finances its leverage with short-term maturities but invests in long-term assets that may become illiquid. This established common practice is raising serious concerns in regard to the stability of financial markets. Hedge funds may also follow other than long/short strategies, including hoarding certain commodities to influence prices and takeovers of companies with extreme leverage, which endanger the companies' futures in order to generate higher returns. Also, highly leveraged currency positions in emerging markets can have a negative impact on the countries involved.

Considerations for Investors

Interested investors face always a challenge in identifying asset classes that are behaving differently (uncorrelated) in order to diversify and

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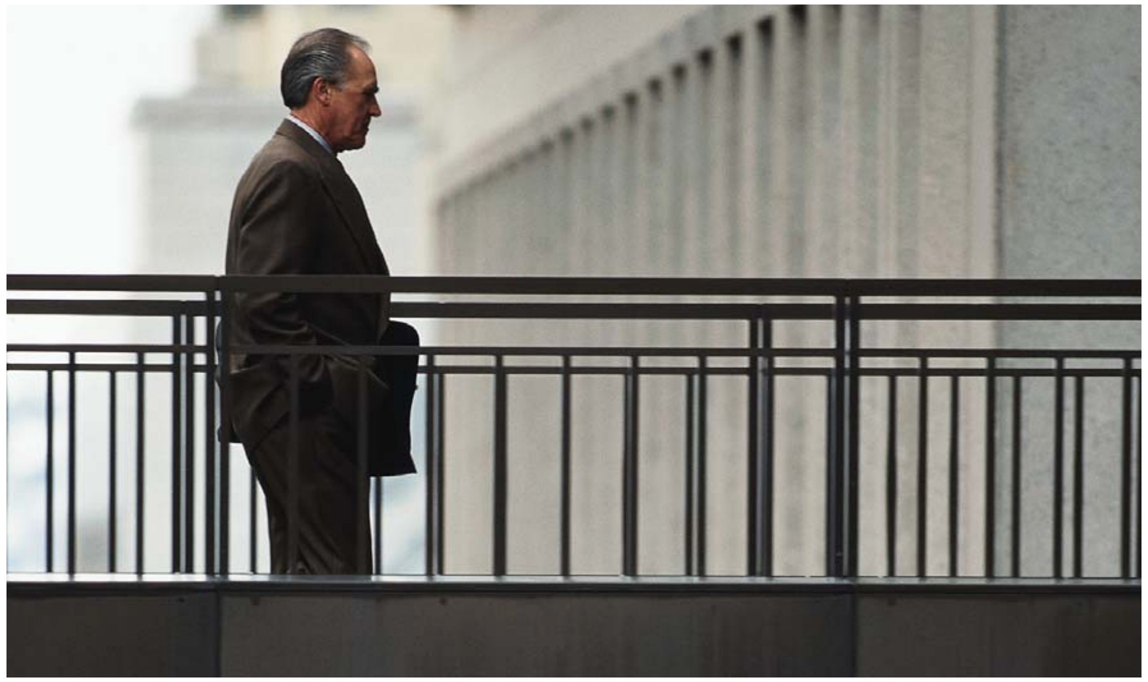
hence reduce portfolio risk. Hedge funds could contribute to such a goal, but careful consideration is needed of the involved risks, especially in regard to excessive leverage and supervision of whether the fund manager upholds the fund's strategy or shifts away from it.

Last not least, the extra performance and risk diversification of hedge funds have a price, which needs to be compared to that of other alternative investments: a 1.5 percent to 2 percent management fee and a 20 percent performance fee for a single fund, and in case of a fund of fund concept, another 1.5 percent and performance fee on top. Does the investment opportunity really offer an outstanding performance not related to market risk that justifies the fees?

In regard to absolute return strategies, it is surprising to see a high correlation between the Eurekahedge indexes of Islamic long-only mutual funds and conventional absolute return strategy funds. It is important to look for different types of hedge funds, by strategy or geography, with a lower correlation. Examples might be a value or macroeconomic event-oriented strategy, with



each raising similar or new Shariah issues.

Before deciding to invest in hedge funds, an investor needs to revisit his goal-based asset allocation. Liquidity, returns and risks are the core criteria, leading typically to investments in fixed income (or substitutes), mutual stocks, real estate and some alternative investments in varying degrees. Efforts in alternative investments should be made only after the core products are covered.

Scant Offerings

For a Muslim investor, it is already challenging to build a portfolio that offers sufficient liquidity, income and reasonable risk diversification. When it comes to alternative investments such as hedge funds, the offerings are fairly restricted and it is difficult to receive detailed investor information to evaluate them. The first offering, the Al Khawarizmi market-neutral fund started 1997 by The International Investor, was closed down about two years ago because it did not attract sufficient assets under management. To date, Islamic hedge fund offers have not been known to attract substantial volumes, unlike their conventional counterparts, which are selling well even in Muslim regions.

Among the players that have announced or are active: Al Fanar US Equity Hedge Fund (US focus; public offer by Permal Asset Management); Gabelli Merger Arbitrage Fund (based on Shariah Capital's platform); Algo Al-Qayyim Fund; Amiri Capital and Swiss-Asia Mashriq Alternative Fund (Japan and Asia focus). Deutsche Bank has introduced a structured investment product with a payoff benchmarked to a conventional hedge fund index as an alternative to a direct hedge fund. Most recently, FIMAT, part of Societe Generale, has begun offering Islamic shorting to prospective hedge funds, acting as a prime broker like Barclays Capital, Citibank, Credit Suisse or Deutsche Bank. FIMAT named the Stark Al-Noor fund, from Wisconsin-based Stark Investments, the Al Raed Emerging Markets fund from London's North of South Capital and a third from an unnamed London hedge fund manager as its initial clients, among others.

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Still Many Questions

It appears possible to use Islamic structures for operating a hedge fund. This, however, does not answer the question of whether the manager of such a fund is really above average, or whether in the individual portfolio, a hedge fund adds value before core strategies are implemented. Another aspect is the boom behind hedge funds, which suggests that the total performance of the hedge fund industry may no longer be above average; poor performance will be more widespread, which 2006 has already shown.●