

# THE ECONOMICS OF MUTUAL FUNDS: AN ISLAMIC APPROACH

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## 1. Introduction

Investments in Islamic mutual funds were estimated at \$1.5 to \$2.0 billion by September 2000, with 102 funds stating that their investments are managed in accordance with the *Shariah* Islamic law.<sup>1</sup> There is no central regulatory body for the Islamic mutual fund industry, and disclosure of information on fund size, types of asset held, fund management objectives and other important matters is entirely voluntary. Some funds provide detailed information, but others provide little more than their business contact details and the types of financial product on offer. Investor protection is a matter for national rather than international regulation, and in all the countries where Islamic funds exist they are treated in an identical fashion to conventional funds.

Of those funds that do provide size information the leasing fund offered by the Islamic Investment Banking Unit of London would appear to be the largest with assets worth over \$200 million. The largest global equity fund disclosing size information is Al Fanar Investment Holdings that is promoted by Worms and Cie, the Swiss private banking group, with \$163 million under management. Some of the most publicised funds are relatively modest in size, notably Flemings Oasis Fund, one of the case studies examined in this paper, which has only \$5.7 million under management.<sup>2</sup>

With an estimated \$900 billion of financial assets held by individuals of high net worth from the Gulf states alone, there is clearly enormous scope for expanding the business of Islamic mutual funds. Just as Islamic banking appeals to Muslims who wish to manage their savings and financing in accordance with their religious beliefs, Islamic fund management appeals to those who wish to adhere to the *Shariah* law with respect to their investment portfolios. There is increasing awareness amongst Muslim investors concerning the *Shariah* law, not least because the Fiqh Academy in Jeddah examined the questions that arise for Muslim investors in financial markets at its seventh session during May 1992, that was widely publicised.

## 2. Objectives and scope

Before reviewing the experiences and some of the issues that arise with Islamic mutual funds it is necessary to examine some of the economic characteristics of mutual funds in general. Does restricting the universe of potentially available investments to ensure *Shariah* compliance adversely affect performance? Hitherto this question could not be answered empirically,

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<sup>1</sup> Tariq Al Rifai, "Monitoring the performance of Islamic equity funds", *New Horizon*, No. 103, October 2000, p. 6. For a complete listing of the funds see pages 10-11.

<sup>2</sup> *Islamic Banker*, No. 56, September 2000, pp. 16-19.

but now a sufficiently long period has elapsed since Islamic mutual funds were first started to provide some examples of how performance can be measured.

Professional publications such as the *Islamic Banker* give details of leading Islamic fund performance in terms of returns over one, three, six and twelve month periods. The returns measured are capital gains and losses. They also publish the performance figures for the two Islamic fund benchmark indices, the Dow Jones Islamic Market Index and the FTSE Global Islamic Index, both of which measure capital gains and losses for companies that are screened for *Shariah* compliance. *New Horizon*, the magazine of the Institute of Islamic Banking and Insurance in London, publish a comprehensive monthly list of Islamic funds obtained from *Failaka* International, and details of the performance of many of these funds can be found on the *Failaka* web site, the data referring to capital gains or losses in the last western calendar year.<sup>3</sup>

In this paper an attempt is made to use more sophisticated measures to assess the performance of Islamic mutual funds that allow for risk adjustments to be made. Two major measures cited in the mainstream finance literature are used, those developed by Sharp and Treynor. The results are reasonably encouraging for investors in Islamic mutual funds.<sup>4</sup>

There are many types of conventional mutual fund to suit the differing financial objectives of investors, such as the desire for a regular income or asset growth. The Islamic mutual fund industry also provides choice to suit differing investor requirements. It would, of course, be impossible to examine the characteristics of the 102 Islamic mutual funds listed by *Failaka* in detail. Nevertheless it can be instructive to take some examples and apply an in depth treatment. The funds selected were largely determined by accessibility to the author, and the managers' willingness to provide detailed information. The two case studies are *Flemings Oasis Fund*, which aimed to provide asset growth through a *Shariah* compliant investment strategy, and the range of funds offered by the London based Islamic Investment Banking Unit of the United Bank of Kuwait, the main objective of which was to provide regular income. Neither of these cases should be assumed to be representative of the Islamic mutual fund industry as a whole, but they do illustrate how Islamic fund managers conduct their business.

### **3. Economics of mutual funds**

Mutual funds is the term used in the United States for pooled funds where the buying and selling prices of the units are directly related to the prices of the underlying stock, unit trusts being the term used in the United Kingdom. Often such investments are referred to as managed funds, as they are professionally managed on behalf of the investors. For investors mutual funds represent an alternative to a savings account with a bank, or holdings of corporate and government bonds or direct investment in company shares.

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<sup>3</sup> [www.failaka.com](http://www.failaka.com)

<sup>4</sup> The calculations were undertaken by Maya Al Sayyad whose master's dissertation I supervised on *The Performance Evaluation of Islamic Unit Trusts*, University of Durham, 2000.

Investment in mutual funds is usually regarded as more risky than holding a savings account with a bank, but less risky than investing in individual securities as the returns are a weighted average of a portfolio of securities.

Mutual funds imply a pooling of investment resources to reduce transactions costs and spread risk. There are four basic advantages for any investor from using fund management services:

1. There are smaller transactions costs as the fund manager can buy and sell stock in large amounts.<sup>5</sup>
2. A broader portfolio diversification which can reduce risk for a given return or increase return for a given risk
3. The ability to participate in new risks, including unquoted companies whose shares are not available on the open market.
4. Professional portfolio management by fund managers who are usually better informed and qualified to make investment decisions than individual investors

This means such funds are especially well suited to investors with limited capital, who do not have the means to acquire a diversified portfolio, and who cannot benefit from the proportionately lower dealing charges associated with large scale share acquisitions and disposals.

The capital in a mutual fund comes entirely from the investment subscriptions, and the legislation and voluntary codes governing such funds limits borrowings from banks. This is one of the distinguishing features of mutual funds in comparison to investment companies, which like other companies, are free to borrow without limit. The consequent gearing in an investment company makes them more risky from the investor's perspective, although it also means they can borrow to take advantage of market opportunities without recourse to the investors.

From an Islamic perspective it is the knowledge that mutual funds cannot borrow that makes them attractive vehicles for investment, and the fact that there is a direct link between the performance of the underlying investment assets and the unit prices which is undiluted by gearing. Mutual funds are inherently transparent and investors gains or losses are dependent on the capital gains or losses and the dividend payments from the underlying equities. Mutual funds are therefore compatible with the principle of profit and loss sharing, which is the essence of Islamic economic justice in financial arrangements.

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<sup>5</sup> Adrienne Johnson, Rachel Hirst, Leslie Cook and Wendy Telfer, *Personal Investment Planning and Advice*, Chartered Institute of Bankers, 1996. The advantages of unit trusts are covered on pp. 373-392 and investments trusts on pp. 407-420.

#### **4. Categories of mutual funds**

There are many different types of mutual funds on offer, and professional advice may be needed to determine which funds are most suitable for individual investors whose financial circumstances and savings objectives may differ. For example older investors who have retired from their jobs may be more concerned with securing a regular income from their assets to maintain their living standards, whereas younger investors in well paid employment may be more concerned with obtaining capital gains so that they can build up their wealth. For the former so called "income" funds may be the most appropriate type of investment, which often involves the fund managers acquiring shares in utilities such as electricity, retail gas or water companies which have a secure income base, but only limited growth potential in mature markets. For those mainly interested in capital gains, funds that invest in "growth" stock may be more appropriate, such as information technology companies whose share prices have risen rapidly in expectation of ever greater market growth, even though current dividend yields have been negligible or extremely modest.

First time investors of limited means may simply want some equity exposure rather than keeping their surplus funds in a bank. Such investors may opt for a balanced or general fund, the managers of which aim to provide a flow of income at least comparable to that available on the average savings account with a bank plus capital growth at least in line with inflation. Bank savings provide interest income, but over time the value of deposits is eroded with inflation unless the interest is rolled up into the account rather than used as income. Equity exposure through mutual fund investments therefore provides greater long-term protection of asset values, as equities can be regarded as a hedge against inflation. For investors who do not want dividend income, most fund management groups offer accumulator schemes, whereby income is re-invested in the fund to acquire additional units rather than redistributed. The decision whether to receive or re-invest income may be influenced by tax considerations, with investors postponing income payments until after they retire from regular employment and enter a lower income tax band.

Investors can also choose whether to pay regular monthly subscriptions into mutual funds or make lump sum investments. The advantage of regular subscriptions is that some units will be purchased when the stock market is in recession and others when the market is booming, which results in price smoothing. Lump sum investments before a rise in market prices are profitable, but those prior to a price fall result in losses. As price movements cannot be perfectly anticipated, lump sum investment is always more risky than regular subscriptions.

Most mutual funds are actively managed, but in recent years there have been an increasing number of "passively" managed funds marketed, usually as index trackers. Active management implies higher charges, as the portfolio has to be constantly monitored, and stock purchased and sold when the performance of the individual companies in which funds are invested changes. With index trackers a portfolio is constructed that mirrors the stock in an index such as the FTSE 100 or Dow Jones 500, the task of the fund

manager being confined to ensure that the weights in the portfolio reflect changes in the value of the stock or similar stock included in the index. With the advent of the Dow Jones Islamic Indices it should be possible to construct Islamic index trackers that are *Shariah* compliant. As funds will still be invested in the component securities of the index, an index tracker should not be regarded as a derivatives fund, even though the value of the index itself is derived from price movements in the constituent stock.

## **5. Fund management of Islamic equity investments**

For Muslims equity investment is certainly preferable to placing funds in interest yielding bonds or certificates of deposit. Muslims, like any other investors, can of course purchase equities directly and build up their own investment portfolios rather than investing indirectly through fund management groups and incurring management charges. The search costs are however higher for Muslim direct equity investors if they want to satisfy themselves that the companies they are investing in are acceptable from the point of view of the *Shariah*. Screening requires a considerable amount of information which can only be ascertained by scrutinising the company's annual reports and accounts, perhaps over a period of several years to discern trends, and discover the extent to which the company has kept to its stated intentions. Skills are also needed to know what figures to use to calculate ratios which are important from an Islamic perspective, notably leverage, the ratio of debt to equity.

Those with large amounts to invest can of course engage their own personal independent financial consultants, accountants, and even *Shariah* advisors, but the problems of interpreting potentially conflicting advice is far from easy. Most Islamic banks are not geared up to providing such an integrated portfolio management service for their more wealthy clients, the favoured alternative being to suggest that the client opens a specified investment account in which the depositor shares in profits of the businesses using his funds rather than the banks profits, as is usually the case with investment accounts.<sup>6</sup> Specified investment accounts approximate closely to a one way multiple *mudarabah* with the bank charging a management fee as intermediary and the client having a direct (one way) relationship with the companies (hence multiple *mudarabah*) being financed. This is not a substitute for an equity portfolio however, as the specified investment is for a fixed time period, and returns are based on profit sharing, not capital gains.

If there were specialist firms of stockbrokers providing dedicated Islamic portfolio management services on behalf of Muslim investors this would be an acceptable alternative to the use of fund management services, but such services have yet to emerge although Islamic investment groups such as Al Rajhi and Al Baraka offer partial services of this type. They are not, however, stock broking companies or equity specialists.

## **6. Compliance in fund management in accordance with the *Shariah***

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<sup>6</sup> Ramadan Shallah, "The experience of the Jordan Islamic Bank," in Rodney Wilson, (ed.), *Islamic Financial Markets*, Routledge, 1990, p. 109 and p. 118.

To ensure that the companies selected for the investment are acceptable from the perspective of the *Shariah*, a fund management group can screen the prospective companies to be included in the portfolio. As with ethical investment selection, both positive and negative criteria can be used.<sup>7</sup> Negative criteria involve excluding companies whose major purpose is the production or distribution of alcohol or pork products or the management of gambling facilities. Investment in conventional *riba* based financial institutions may also be regarded as *haram*. Some investors may be concerned with political criteria, viewing companies involved in Israel as threatening the legitimate interests of Muslims in Jerusalem. On the other hand companies that are promoting trade with Muslim countries may be viewed positively, as will companies involved in the economies of the Islamic world through their investments.

Some investors may prefer to avoid investing in airlines, hotels or supermarket chains that serve or sell alcohol, even though this is a minor part of their business. This would however result in a much more restricted potential portfolio selection. Usually business are defined by their prime activity, which makes a hotel group or airline acceptable, but a brewery unacceptable. There are parallels with ethical investment funds that avoid investing in tobacco companies, but may invest in retail groups selling cigarettes alongside other items.<sup>8</sup>

The issue of leverage is complicated. Ideally it would be desirable to avoid investing in companies which have any involvement with *riba* based banks, but this would mean the exclusion of virtually all quoted companies, including those whose stocks are traded in the equity markets of Muslim countries. In practice fund management groups seeking to comply with the *Shariah* adopt two criteria. First they examine the extent to which a company's income is derived from interest, any proportion in excess of 15 per cent being unacceptable. The second criterion is to consider the extent of debt to total assets, a proportion in excess of one third being unacceptable. Rushdi Siddiqi advocated tighter criteria, with a limit of 25 per cent for the debt to capitalisation ratio, but there is no consensus on this.<sup>9</sup>

The *Fiqh* Academy has decreed that dealing in preference shares is not permitted under resolution 63 of 1992,<sup>10</sup> but there is no restriction in dealing in ordinary company stock. Shares issues may be underwritten under item 2, which could be applied to the redemption undertakings of mutual funds. Payments for shares can be made on an instalment basis under item 3, which has particular relevance for monthly planned investment schemes involving mutual funds. Under item 9 fees can be charged for the issue of shares, which

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<sup>7</sup> Christopher J. Cowton, "The development of ethical investment products," in Andreas Prindl and Biman Prodhan, (eds.), *Ethical Conflicts in Finance*, Blackwell, Oxford, 1994, pp. 213-232.

<sup>8</sup> Alan Lewis and Tony Cullis, "Ethical investments: preferences and morality," *Journal of Behavioural Economics*, Vol. 19, No. 4, pp. 395-441.

<sup>9</sup> Rushdi Siddiqi, "Islamic equity benchmark: a measure to measure", *Islamic Banker*, no. 27, April 1998, pp. 7-8.

<sup>10</sup> *Fiqh Academy* 7<sup>th</sup> session, Resolution 63, 1992, item no. 6.

could arguably be applied to the management charges levied by mutual funds.

## **7. Financial monitoring of Islamic mutual funds**

Until recently there have been no international benchmark indices for Islamic equity investments, but in 1999 Dow Jones launched the Islamic Market Index<sup>11</sup> and the Pearson Group, owners of the Financial Times, launched the FTSE Global Islamic Index. These provide benchmarks from which to evaluate the performance of Islamic equity based mutual funds. Indeed the introduction of these indices should encourage the development of further Islamic mutual funds. Regional and sectoral Islamic market indices are also planned by Dow Jones which should enable more specialist Islamic funds to have an appropriate standard against which performance can be evaluated. An Islamic index of securities traded on the New York Stock Exchange drawn from the United States Dow is already available, as is an Islamic index based on technology stock world-wide. In both cases the companies comprising the relevant Dow Jones index have been screened for *Shariah* compliance and the remaining companies indexed.

A *Shariah* Supervisory Board has advised Dow Jones on the criteria to be adopted when including companies in the index. Members of the Board include very respected Islamic scholars, notably Dr Abdul Sattar Abu-Ghuddha, Justice Muhammad Taqi Usmani, Dr Muhamed Elgari, Sheikh Nizam Yaquby and Sheikh Yusuf Talal DeLorenzo.<sup>12</sup> The primary business of the companies included in the index must be *halal*, which means businesses involved in conventional banking, alcohol, pork and gambling are excluded. Three financial screens are applied to determine which of the remaining companies to include:

- Total debt as a percentage of total assets must be less than 33 percent,
- Accounts receivable as a percentage of total assets must be less than 49 percent,
- Interest income as a percentage of operating income must be less than 10 percent.

The universe from which companies are selected is the Dow Jones Global Index comprising almost 3,000 companies in 33 countries covering 10 economic sectors and 122 industry groups. Of these after screening around 600 companies qualify for inclusion in the Dow Jones Islamic Market Index, these being quoted in 30 countries. The total market capitalisation of companies included in the Islamic Market Index is \$74 trillion.

The base date for the index is December 31<sup>st</sup> 1995, with the base value set to 1000.<sup>13</sup> The index is capitalisation weighted and calculated in real-time for dissemination to major market data vendors such as Datastream. Table 1 shows its performance since the base date in comparison an Islamically screened United States Dow Jones index and an Islamically screened world

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<sup>11</sup> Rushdi Siddiqui, who manages the Dow Jones Islamic Market Index, was interviewed by the *Arab Banker*. See Vol. 6, No. 4, Spring 1999, pp. 12-16.

<sup>12</sup> Details of the board are available on the Web at:

<http://averages.dowjones.com/djimi/imboard.html>

<sup>13</sup> <http://averages.dowjones.com/djimi/imfeat.html>

technology index. Capital gains since December 31<sup>st</sup> 1995 are in line with those of corresponding unscreened stock in each category, and the spreads between highs and lows are similar, with particular price volatility in technological stocks, but substantial capital gains on average.

Table 1: Dow Jones Islamic Market Indices

Index	World	US Dow	World Technology
Close price	1953.91	2276.58	2958.86
12 month high	1988.63	2357.03	3185.15
12 month low	1428.74	1640.46	1723.86
Change in 1999	155.49	128.53	282.58
% change in 1999	8.64	5.98	10.55

Note: Base date 31st December 1995, base value 1000.

Source: Dow Jones

Returns and volatility are reported in table 2, with the Dow Jones Islamic Market Index outperforming the other world indices over the 1996-98 period in terms of capital gains, but with similar average annual price volatility.

Table 2: Returns and volatility of the Dow Jones Islamic Market Index in comparison with leading indices, 1996-1998, %.

	Returns	Volatility
Islamic Markets Index	99.57	12.94
DJ United States	101.17	16.46
DJ World	50.20	12.56
S&P 500	79.84	16.76
MSCI World	65.21	12.71

Source: Dow Jones

Table 3: Correlation of the Dow Jones Islamic Market Index with leading indices, 1996-1998, %.

	S&P 500	DJ US	DJ World	Islamic Index	MSCI World
S&P 500	100.00				
DJ US	99.86	100.00			
DJ World	82.01	82.69	100.00		
Islamic Index	92.26	92.52	94.74	100.00	
MSCI World	83.91	84.61	96.62	93.35	100.00

Source: <http://averages.dowjones.com/djimi/imperf.html>

Not surprisingly the Dow Jones Islamic Market Index is closely correlated with the other leading indices in terms of returns over the 1996-1998 period as table 3 shows, but there does not appear to be a significant difference whatever conventional index which is chosen. This indicates that Islamic investors need not suffer financially because of the screening process.

## 8. Investment reporting on Islamic Mutual Funds

An important source of information on Islamic mutual funds is *Failaka*, a United States based organisation that tracks and publishes performance

results for Islamic equity funds.<sup>14</sup> They provide a newsletter and quarterly reports on leading Islamic mutual funds for regular subscribers. Islamic financial institutions sharing fund data with *Failaka* receive a 50 percent discount on their subscriptions. Until *Failaka* was established there was no dedicated investment analyst service for Islamic mutual funds similar to the type of service that the stockbroker Holden Meehan provides for ethical investment in the United Kingdom for ethical investors.<sup>15</sup>

It is worth stressing that *Failaka* is a financial information provider rather than a stockbroker. There remains a gap in the dedicated provision of Islamic stockbroking services in the West. Many Islamic banks and conventional banks offering Islamic investment management facilities offer such services, but they usually have to operate through established general stockbrokers. Greg Middleton, a leading independent stockbroker in the United Kingdom, has stated to provide a dedicated service for Islamic investors, but this is only a minor part of its business.

Table 4: Ten leading Islamic global equity fund returns in 1999

Fund	Promoter	Location	Inception	1999 %
Citi Global Portfolios	Citi Islamic Investment Bank	Bahrain	Oct 1997	55.0
Al Dar World Equity	The International Investor	Kuwait	Feb 1998	47.1
Miraj Global Equity	Miraj International Investment	Canada	Aug 1998i	40.5
Al Rajhi Global Equity	Al Rajhi Banking	Saudi Arabia	Jul 1996	38.0
Alfanar Investment Holdings	Permal Asset Management	United States	Dec 1997	36.7
Hegira Global Equity	Wellington Management	United States	Sept 1996	31.0
Al Baraka Global Equity	Al Baraka Investment Bank	Bahrain	Dec 1997	30.4
Al Ahli Global Trading Equity	National Commercial Bank	Saudi Arabia	Jan 1995	27.3
GAM Alkawtharr	Al Baraka Investment Bank	Saudi Arabia	Aug 1997	24.9
Flemings Oasis International Equity	Robert Flemings	Bahrain	Mar 1996	24.3

Source: Failaka International

<sup>14</sup> [www.Failaka.com/Invest.html](http://www.Failaka.com/Invest.html)

<sup>15</sup> For a discussion of the performance of ethical funds and the role of Holden Meehan see Rodney Wilson, *Economics, Ethics and Religion*, Macmillan, London and New York University Press, 1997, pp. 193-196.

Equity funds are ranked by category by *Failaka*, the most successful global fund in 1999 being that offered by the Citi Islamic Investment Bank as table 4 shows. It is managed in-house. Many promoters of Islamic funds use external professional fund management groups to handle the investments, while they concentrate on the marketing. The Institutional Investor, whose Al Dar Fund was second ranked, is managed by Pictet and Cie, the Geneva based private banking group. The Royal Bank of Canada manages the third placed Miraj fund.

Islamic funds are often criticised for recycling the funds from wealthy investors from developing countries of the Muslim world into the West, usually into the United States and Europe, where there is less country risk and markets are less volatile. There are over twenty Islamic mutual funds however which focus on emerging markets, the ten best performers in 1999 being listed in table 5. Many are based in Malaysia, which has the largest stock market in the Muslim world.

Table 5: Ten leading Islamic emerging market fund returns in 1999

Fund	Promoter	Location	Inception	1999 %
Mendaki Growth	Mendaki Holdings	Singapore	Sep 1997	55.3
Mendaki Asia	Mendaki Holdings	Singapore	May 1991	52.1
Ibn Majid Emerging Markets	The International Investor	Kuwait	Nov 1995	49.1
Tabung Ittikal	Arab-Malaysian Unit Trusts	Malaysia	Jan 1993	45.5
Amanah Saham Kedah	Amanah Saham Kedah	Malaysia	Feb 1995	43.5
Pure Specialist Fund	Futuregrowth Unit Trust Management	South Africa	June 1992	42.2
RHB Mudharabah	RHB Unit Trust Management	Malaysia	May 1996	35.7
Al Dar Eastern European Equities	The International Investor	Kuwait	Feb 1998	33.5
Al Rajhi Middle East Equity	Al Rajhi Banking and Investment	Saudi Arabia	May 1998	33.0
Al-Ahli Saudi Trading Equity	National Commercial Bank	Saudi Arabia	June 1998	27.2

Source: Failaka International

## 9. Performance of Islamic Mutual Funds

When measuring performance standard indicators such as the Sharpe measure that take account of risk may be appropriate,<sup>16</sup> but some modification may be needed in the light of *Shariah* teaching, that may require further investigation by Muslim legal scholars. Specifically the Sharpe performance measure (SHP) takes account of the risk-free interest rate, which is exactly that element of interest that constitutes *riba*. Formally:

$$\text{SHP} = (\mu_i - r_f) / \sigma_i$$

<sup>16</sup> Cheol S. Eun and Bruce G. Resnick, *International Financial Management*, Irwin McGraw Hill, 1998, p. 279.

where  $\mu_i$  is the mean return,  
 $\sigma_i$  is the standard deviation of returns and  
 $r_f$  is the risk free interest rate.

In other words the Sharpe return represents the excess return above and beyond the risk free interest rate per standard deviation of risk. This excess could be considered a justified reward for risk taking under the *Shariah* law, but the legitimacy of  $r_f$ , the risk free interest rate must be questioned, although not necessarily set to zero.

Table 6: Sharp performance measures for selected Islamic mutual funds

	Fund	DJIM	Performance
Amana Growth	0.1416	0.1709	↓
Amana Income	0.0592	0.1709	↓
Flemings Oasis	0.0640	0.1717	↓
Ibn Majid	0.0116	0.1729	↓
Al Khawarizmi	-0.0919	0.1917	↓
Al Dar Europe	-0.0332	0.4916	↓
Al Dar Eastern Europe	-0.1068	0.4916	↓
Al Dar World	0.2024	0.4916	↓
TII Small Capital	0.3272	0.4588	↓
Al Kawthar	0.0650	0.1286	↓
Miraj	0.2490	0.36118	↓
Al Bukhari	0.1537	0.2346	↓

Estimated by Maha Al Sayyad. See footnote 2.

Sharp ratios for the 12 leading Islamic mutual funds are reported in table 6. Data availability determined the selection of funds, with weekly data analysed for the period since the start of each fund. For each fund the performance is compared with that of the Dow Jones Islamic Markets Index (DJIM) over the period since the fund started operating. The final column shows the relative performance, with the down arrows indicating that all the funds underperformed the DJIM.

Treynor provided an alternative to the Sharp performance measure. Rather than measuring the excess returns per unit of standard deviation, this measure uses the beta of a portfolio,  $\beta_p$ .

$$TRP = (\mu_i - r_f)/\beta_p$$

The beta of a portfolio is simply the standard deviation of the portfolio divided by the standard deviation of the returns from the market as a whole. To determine beta this is multiplied by the correlation between the portfolio and the market portfolio to determine what portion of the relative uncertainty will

not be diversified away when the portfolio is held.<sup>17</sup> In other words the portfolio beta refers to the systematic risk of the portfolio as measured against the relevant benchmark.

The results reported in table 7 are more encouraging than those using the Sharp measure, as 5 of the 12 funds outperformed the DJIM, the best relative performances being those of the Ibn Majid, TII Small Capital and Miraj funds.

Table 7: Tryenor performance measures for selected Islamic mutual funds

	Fund	DJIM	Performance
Amana Growth	0.00357	0.00326	↑
Amana Income	0.00147	0.00326	↓
Flemings Oasis	0.00173	0.00332	↓
Ibn Majid	0.00929	0.00350	↑
Al Khawarizmi	-0.04942	0.00903	↓
Al Dar Europe	-0.05232	0.00396	↓
Al Dar Eastern Europe	-0.01072	0.00396	↓
Al Dar World	0.00589	0.00396	↑
TII Small Capital	0.02470	0.001139	↑
Al Kawthar	0.00193	0.00282	↓
Miraj	0.07638	0.01579	↑
Al Bukhari	0.00862	0.01206	↓

Estimated by Maha Al Sayyad. See footnote 2.

## 10. Flemings Oasis Fund

Flemings Oasis Fund was specifically established by Britain's oldest independent investment bank to serve the needs of Islamic investors. The objective was long term asset growth through investment in a diversified portfolio of international equities which were monitored for *Shariah* compliance.<sup>18</sup> The Oasis Fund was set up as an open-ended investment company which was recognised by the United Kingdom's Securities and Investment Board under the provisions of the Financial Services Act of 1987. Considerable preparation and research was undertaken by Flemings before the launch of the Fund in May 1996, including extensive consultations with Islamic scholars.

The fund performed reasonably well, but only attracted attracted \$5.7 million from Muslim investors during its short life. Consequently following the take over of Flemings by the United States investment bank Chase, a decision was taken in September 2000 to liquidate the fund and return the money at the then current value to the investors. Despite this unfortunate development, it is instructive to examine the experience of the fund to see what lessons can be learnt. One issue is that of creditability: whether it is possible for a western

<sup>17</sup> Robert Radcliffe, *Investment: Concepts, Analysis, Strategy*, Addison Wesley, 1997, 5<sup>th</sup> edition, pp. 267-268.

<sup>18</sup> *The Key Features of the Oasis Fund: Regulated Collective Investment Scheme*, Flemings, London, May 1999, p. 1.

institution to be seen as a fit manager of Islamic funds even if it has a distinguished *Shariah* committee.

### **10.1 *Shariah* Compliance**

The Fund has a *Shariah* board comprising three respected Islamic legal scholars: Dr Abdul Sattar Abu , who also serves as a *Shariah* advisor to the Dallah Al Baraka Group, Justice Taqi Uthmani, who is an advisor with the Bahrain Islamic Bank and the IIBU of the United Bank of Kuwait, and Dr Nazih Hammad, who taught for 17 years at Um-Al Quora University in Mecca.<sup>19</sup> Both Dr Ghuddah and Dr Hammad are members of the Islamic Fiqh Academy in Jeddah, and Justice Uthmani is Deputy Chairman of the Academy. Dr Ghuddah and Dr Hammad have degrees from Damascus and Cairo Universities and Justice Uthmani took his degrees in Pakistan.<sup>20</sup>

The *Shariah* Board meets three times annually, and emergency meetings can be called at ten days notice if necessary.<sup>21</sup> A researcher is employed by the *Shariah* Board to prepare reports for the meetings, to keep the minutes and to notify the fund management of the resolutions passed. The researcher is actively involved in the preparations for the *Shariah* audit of the companies the fund includes in its investment portfolio.

The company shares included in the Oasis Fund are selected from those included in the Morgan Stanley Capital Markets Index (MSCI), a universe of over 2,600 stock traded in leading international markets. The initial screening involves the removal of industrial sectors deemed to be unacceptable for Islamic investment such as conventional banking. Then individual companies are removed, such as those involved in brewing or distilling, or the manufacture or sale of pork products. Highly leveraged companies are also removed, as excessive borrowings on the basis of *riba* is unacceptable.

The guidelines on gearing were changed in 1999 following consultations involving the *Shariah* Board and other *Fiqh* scholars. Rather than defining gearing as the ratio of total debt to assets, the new definition takes the ratio of total debt to the market value of equity. There is less scope for disagreement with this new definition, as asset values can include goodwill, which is a subjective valuation. Furthermore the value of total assets is an historical measure, whereas the market value of equity constantly changes with the share price.

The target for gearing is now more precise, as at the original objective was simply to have the portfolio debt asset ratio substantially below the average for the MSCI markets index without specifying an exact ratio. Since 1999 the target ratio of total debt to the market value of equity is specified as 30 percent, which is in line with the targets for *Shariah* compatibility set by other similar funds.

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<sup>19</sup> *Islamic Banker*, February 1996, p. 3.

<sup>20</sup> Flemings investment presentation, February 1999, p. 3.

<sup>21</sup> Flemings Oasis Fund Prospectus, Luxembourg, 1995, p. 32.

As companies that are included in any equity portfolio will have some interest earning assets, it is necessary to “purify” any income to ensure it is not tainted by *riba*.<sup>22</sup> In the case of the Oasis Fund a deduction of 0.5 percent is made from the net asset value of the companies included in the portfolio to allow for any interest earnings. There is also provision for an amount to be deducted with respect to un-Islamic activities, but because of the comprehensive nature of the screening process, this further deduction has not proved necessary to date. In order that the purification deductions are shared fairly between investors a deduction is made weekly on the dealing day, as a less frequent deduction would mean that those who sold their shares before purification would potentially have a small part of their gains tainted by *riba*.

The money deducted through the purification process is donated to charities, which are nominated by members of the *Shariah* supervisory committee. The *Shariah* committee regularly reviews the purification formula and is asked for advice regarding potential un-Islamic activities.

### **10.2 Investment Selection**

Having applied *Shariah* screening criteria Flemings apply investment screening criteria to the remaining stock to determine what to include in the portfolio. Investments are only made in companies that have made no dividend cuts in the last five years, that produce a dividend yield plus dividend growth above the country average, and have a stable payout ratio. If companies are forced to increase their payout ratios to maintain dividends this may not be sustainable in the longer term. Leverage should be below industry and country averages, not only to ensure *Shariah* compliance, but also because companies with high levels of debt are regarded as a poor risk. The valuation of the companies selected for inclusion should not be excessively high, as the purchase of over-valued shares is not a good financial proposition.

The portfolio valuation characteristics of the Oasis Fund is shown in table 8 which highlights the differences between the old and new portfolios adopted when the leverage definitions and criteria were changed. The price to earnings ratio is relatively high, although below that for the companies included in the MSCI World Index, and the yield is relatively low. This reflects the emphasis on capital growth rather than dividend income by the fund managers.

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<sup>22</sup> Ibid., p. 13.

Table 8: Portfolio financial characteristics

	Old Portfolio	New Portfolio	MSCI World Index
Price/Earnings	26.1	27.0	29.8
Price/Book Value	2.8	4.7	3.6
Yield	1.9	1.2	1.5
Leverage (old)	35	36	47
Leverage (new)	26	14	41
Pay-out ratio	50	33	45
Return on earnings	10.7	17.5	12.1

Source: Quantitative Portfolios Group, Flemings Asset Management

The geographical breakdown of asset allocation is given in table 9, which shows that over half of the investments are in North America, mainly in companies quoted in Wall Street. The United Kingdom is under-represented reflecting the fact that the Oasis Fund is dollar denominated and the potential exchange rate risks with sterling. Japan is slightly over-represented, reflecting the fund management view that the Tokyo market is poised for recovery, and Japanese stock can be purchased at relatively attractive prices.

Table 9: Asset allocation by region

	Old Portfolio	New Portfolio	MSCI World Index
N. America	51.4	52.5	53.6
Europe x UK	29.1	24.4	23.4
United Kingdom	6.1	5.4	10.1
Japan	11.8	13.4	9.8
Asia x Japan	1.9	4.3	2.5

Source: Quantitative Portfolios Group, Flemings Asset Management

The asset allocation by industry in table 10 shows that energy companies account for a smaller proportion of the new portfolio reflecting the poor price performance of many of these companies. Shares in BP Amoco have been retained, but those in smaller companies such as Duke Energy, Teikoku Oil and even the Royal Dutch Petroleum Company have been sold. Shares in telecommunications companies such as AT & T have been added, as well as computer companies such as Compaq, Computer Associates, Hewlett-Packard, Oracle and Sun Microsystems. Capital and consumer goods are over-represented in the portfolio, whereas shares in banks are excluded.

Table 10: Asset allocation by industry

	Old Portfolio	New Portfolio	MSCI World Index
Energy	17.3	4.9	8.7
Raw materials	15.0	8.6	4.4
Capital goods	19.9	26.7	13.5
Consumer goods	23.4	37.6	21.9
Services	21.3	22.2	28.7
Finance	0.0	0.0	19.4
Other	3.2	0.0	3.3

Source: Quantitative Portfolios Group, Flemings Asset Management

### 10.3 Charges and Expenses

The Oasis Fund is registered in Luxembourg where there is no capital gains tax, withholding tax on dividends, or stamp duty, although there is a tax of 0.06 per year on its net asset values. The minimum initial investment is \$50,000 for each investor, which can be increased by a minimum of \$10,000 per purchase for investors who wish to increase their holdings. There is an initial management charge of 5 percent of investor's subscription and a management fee of 1.75 percent per year, as well as a redemption fee of 0.5 percent.<sup>23</sup> The spread between the bid (buying price) and offer (selling price) is 5.5 percent, inclusive of the redemption fee.

These management charges are relatively high, but it can be argued that the costs of operating an Islamic fund are higher than a conventional fund given the additional monitoring involved. The fees and expenses of the *Shariah* supervisory board, custody fees and audit fees are estimated to amount to 1.5 percent per year. In addition there is an allowance for a purification deduction of 0.3 percent per year.

### 10.4 Fund Performance

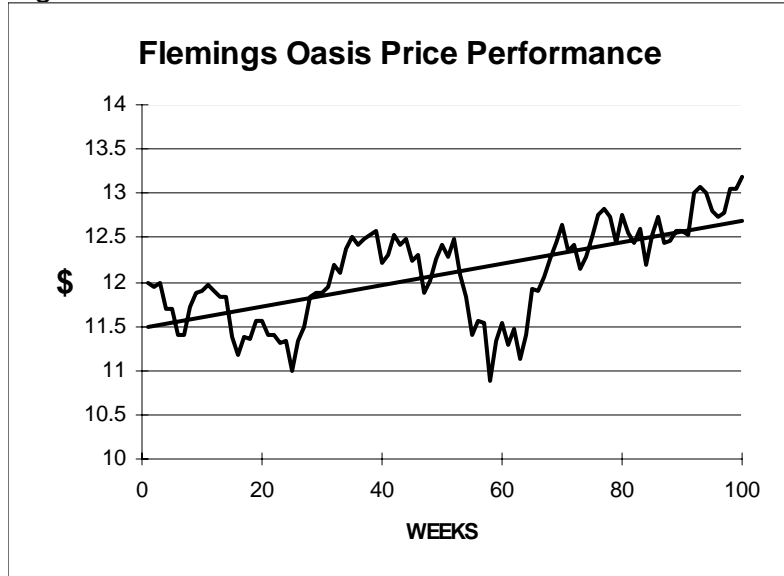
The fund got off to a satisfactory start with \$16.6 million initially subscribed and a target of \$30-\$60 million by the end of 1996.<sup>24</sup> By July 21<sup>st</sup> 1999 the selling price of the units was \$13.0586 and the buying price \$13.7459, over a 30 percent rise on their issue price in 1996.<sup>25</sup> The price performance over the first 100 weeks since the prices were available from *Datastream*, the on-line financial statistics provider, are shown in figure 1, the period covered being from last week of July 1997 until July 1999. Prices are calculated every Tuesday, the dealing day for subscriptions and redemptions.

<sup>23</sup> Simon Salwan, *Islamic Equity Funds*, MSc dissertation, University of Manchester Institute of Science and Technology, 1997, p. 67.

<sup>24</sup> *New Horizon*, July 1996, p. 12.

<sup>25</sup> *Financial Times*, July 21<sup>st</sup> 1999, p. 41. Prices are also quoted daily in the *International Herald Tribune*.

Figure 1



Often capital gains are associated with price volatility, which can be considered as a measure of risk. The volatility as measured by the population standard deviation using weekly data for half-year periods is shown in table 11. The standard deviations are relatively low, and have actually declined over the 1997-99 period, which demonstrated limited price volatility.

Table 11: Variation in Fleming's Oasis unit prices

	Standard deviation	Mean price, \$
1997 2	0.26	11.63
1998 1	0.27	12.00
1998 2	0.22	11.91
1999 1	0.22	12.71

Source: Estimated by the author from *Datastream* statistics

### 11. Islamic Investment Banking Unit

The Islamic Investment Banking Unit (IIBU) is a wholly owned subsidiary of the United Bank of Kuwait. Kuwait's financial links with the United Kingdom date back to the 1920s and 1930s, the period prior to oil development. As oil became more important and the overseas assets of Kuwait grew, the major Kuwaiti banks decided in 1966 to jointly establish a bank in London, the United Bank of Kuwait, to serve the trading and financial interests of their clients in the West, including the Kuwaiti government. This bank is a fully-fledged United Kingdom registered bank, regulated by the Bank of England, and not merely a representative office. Initially following independence in 1961 most of Kuwait's overseas assets were held in sterling, but with the devaluation of sterling in 1967, and oil related dealings in dollars, an increasing amount of business was dollar dominated. Business flourished in the 1970s and 1980s, but most of it involved conventional rather than Islamic finance, and the Kuwait Finance House, Kuwait's Islamic bank, was not a shareholder.

By the mid 1980s there was an increasing demand from the bank's Gulf clients for Islamic trade based investment, and the bank started to provide these facilities in 1984. Following the initial success of the Islamic financing business the decision was taken in 1991 to open a specialist Islamic Banking Unit within the bank. New staff members were recruited with considerable experience of Islamic finance to manage the unit, which enjoyed considerable decision making autonomy. In addition being a separate unit, accounts were separated from the main bank, with Islamic liabilities on the deposit side matched by Islamic assets, mainly trade financing instruments. The unit has its own *Shariah* advisors, and functions like an Islamic bank, but is able to draw on the resources and expertise of the United Bank of Kuwait as required.

In 1995 the renamed Islamic Investment Banking Unit (IIBU) moved to new premises in Baker Street, and introduced its own logo and brand image to stress its distinct Islamic identity.<sup>26</sup> Its staff of 18 in London and 7 in New York include asset and leasing managers and portfolio traders and administrators, and investment business is now generated from throughout the Islamic World, including South East Asia, although the Gulf remains a major focus of interest.<sup>27</sup> Assets under management exceed \$1.1 billion as a result of rapid growth in recent years. The IIBU has sought in recent years to expand its product range, and now offers Islamic mortgages, branded as *Manzil* financing in the United Kingdom and the United States. It is the fund management facilities, however, that are considered here, as the *Manzil* scheme has been written about elsewhere.<sup>28</sup>

The IIBU has established five separate funds in which money can be invested in accordance with the *Shariah* law, the aim being to provide Muslim investors with attractive and competitive returns from real assets. Supervision is provided by the IIBU's *Shariah* advisors, who include Justice Taqi Uthmani, to ensure compliance with Islamic law.

In August 2000 a merger between the Al-Ahli Commercial Bank and the United Bank of Kuwait was agreed, the new institution to be called the Alhi United Bank.<sup>29</sup> The IIBU is continuing within the new bank, but some of its senior staff left to set up a new Islamic banking unit within the London office of the Arab Banking Corporation. As its work is at an early stage, it seems appropriate to review the IIBU, which unlike Flemings, will be continuing to service existing Islamic financial products and provide new products.

### **11.1 IIBU Leasing Fund**

The leasing fund was launched in April 1994 as a non-interest bearing equivalent to fixed income bonds. The aim is to generate a good income stream and provide modest capital gains from the ownership and leasing of capital equipment assets. Quarterly dividends are payable, with purchases

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<sup>26</sup> *New Horizon*, December 1995/January 1996, p. 24.

<sup>27</sup> *New Horizon*, July 1996, p. 17.

<sup>28</sup> Adeel Yousuf Siddiqi, "Islamic mortgages in Europe: a big market not yet fully tapped", *New Horizon*, February 1998, p. 2.

<sup>29</sup> *Islamic Banker*, September 2000, p. 4.

and redemption in July, October, January and April. The dividend target is 1 to 3 percent in excess of short-term money market rates after fees, and to achieve further profits by re-leasing and selling equipment on maturity. The initial entry fee is 2.5 percent of the amount invested, and in addition there is a management fee of 1.5 percent per annum and a custody and administration fee of 0.3 percent per annum.<sup>30</sup> The fund is targeted at investors with substantial funds rather than small investors, many of whom are clients of the United Bank of Kuwait or the institutions owning the bank.

The fund is dollar denominated, and most of the equipment purchased for leasing is United States domiciled. The intention is to conduct at least 75 percent of the business within the United States, and confine the leasing to "low tech" equipment. The fund itself is based in the tax free zone in Dublin to avoid withholding and other taxes. Table 12 provides information on the equipment costs and number of lessees, leases, asset types and industrial sectors. The equipment purchased includes warehousing vehicles such as fork lift trucks, production line equipment, earth moving equipment for the construction industry and point of sales electronic equipment for retailers. Clients include Sony Electronics, Ball Foster and Williams Sonoma and other similar highly rated companies. Trucks are the largest single asset type accounting for around 13.5 percent of the total, followed by forklifts and low technology manufacturing plant. Aircraft leases account for 2 percent of the total, and aircraft parts a further 2 percent.

Table 12: IIBU Leasing fund characteristics

	27/10/98	26/1/99	31/5/99
Equipment cost	\$285,969,199	\$291,208,798	\$318,398,491
Lessee credit quality	A-	A-	A-
No. of lessees	110	111	109
No. of leases	912	941	848
No. of asset types	19	20	22
No. of industrial sectors	24	24	24

Source: IIBU *Leasing Fund Monthly Report*, May 1999

The performance of the fund is shown in table 13, which shows that the managers meet their objectives of maintaining a return comfortably above LIBOR and US treasury bills. The margin above treasuries has fallen slightly during 1999, but this largely reflects a rise in treasury bill rates, while the annualised dividend yield of the fund has advanced more modestly.

<sup>30</sup> IIBU *Leasing Fund Prospectus*, 1999

Table 13: IIBU Leasing fund performance

	27/10/98	26/1/99	27/4/99
Fund net asset value	\$203,5559,242	\$291,208,798	\$318,398,491
Shares in issue	2,035,991	2,014,461	1,934,561
NAV per share	\$100	\$100	\$100
Annualised dividend yield	7.06%	6.01%	6.10%
6 month LIBOR	5.75%	5.00%	4.96%
1 year treasuries	5.33%	4.06%	4.49%
Margin above treasuries	+1.73%	+1.95%	+1.61%

Source: IIBU *Leasing Fund Monthly Report*, May 1999

### 11.2 IIBU Student Property Leasing Fund

The student property leasing fund is a five year offshore property fund which aims to provide a projected cash return of 9 to 11 percent per annum to investors after all management charges are covered. Dividends are paid quarterly and the fund aims to provide additional capital gains at the end of the five year period. The fund is sterling denominated, with a minimum subscription of £100,000. An entrance fee of 1.5 percent is charged on subscriptions up to £250,000 and a reduced fee of 1 percent for subscriptions above that amount.<sup>31</sup> The annual management fee is 1.5 percent. There is no exit charge for funds held for the full five year period, and if investors want to sell their shares before that time, the United Bank of Kuwait provides an underwriting facility every six months for repurchases. For investors who remain with the fund for the full five years total returns could rise to 15 percent per annum allowing for capital growth as well as the investment income.

The fund was established in 1998, and acquisitions of student property began in the spring of that year. The fund aimed to attract funds worth £30 million, and by June 1999 almost £17 million had been invested in property throughout the United Kingdom. The fund is structured in accordance with Islamic principles and is unleveraged. Universities in the United Kingdom lack the capital to provide accommodation for their increasing student populations, which provides scope for private financing arrangements such as that provided by the fund.

Rooms are rented to students on an Assured Shorthold Tenancy Agreement which legally binds the occupants for a period of a year. Rents are paid for 10 months at full rent, and the two summer vacation months at half rent. The properties acquired are suitable for renting at above average rates, as the aim has been to target the more affluent sector of the student rental market, where parents can provide appropriate financial guarantees of rent payments. Interest free deposits are taken from prospective tenants.

Details of the properties acquired are provided in table 11, the residences being in prime urban locations close to the university campuses. This type of property has a good potential for growth in value, as prices in provincial cities are below those in London, where some property prices are arguably overvalued. Continuing expansion in student numbers means high demand for

<sup>31</sup> IIBU Student Property Leasing Fund, *Investment Prospectus*, 1998, p. 8.

well located accommodation, especially in provincial cities which the British Labour government favours for university and further education expansion. At present higher education accounts for 32 percent of the relevant age group, but this proportion is expected to rise to 45 percent over the next 20 years. Further expansion in the student population at masters degree level is occurring, and as such courses usually require 12 months of residence, this group of tenants is especially attractive to landlords.

Table 14: Portfolio of the Student Property Leasing Fund

Property	Acquisition cost (£)
48 Royal Park Road, Hyde Park, Leeds	690,135
14 Welton Road, Hyde Park, Leeds	223,453
16 Tapton House Road, Sheffield	554,711
Clifford House and St Andrews House, Sheffield	530,000
Masters House, Histon Road, Cambridge	2,103,100
Brook Hill Close, Woolwich	1,553,000
Porterbrook Mews, Sheffield	523,000
Student Village, Liverpool	4,800,000
Charlotte House, Newcastle	2,715,000
Hull Student Portfolio	3,189,458
Denison Court, Nottingham	2,850,000

Source: IIBU Student Property Leasing Fund, *Interim Investment Summary*, June 1999, p. 4.

The property advisor to the fund, Waters and Company, was taken over in 1999 by the Interior Services Group, a larger property management and advisory group with interests throughout the regions of the United Kingdom. The fund is registered in Guernsey for tax purposes where it is audited by BDO. Returns in 1999 were over 9 percent,<sup>32</sup> within the target band for ongoing dividends, and the margins over interest returns have increased, as the latter have been adversely affected by the reductions in base rates brought about by the Monetary Policy Committee of the Bank of England. By the summer of 1999 base rates stood at 5.25 percent, compared to 7.5 percent in October 1998.

### **11.3 IIBU Healthcare Fund**

The IIBU Healthcare Fund was established in December 1996 as a joint venture between the IIBU and the Kuwait Finance House, the major Islamic financial institution in Kuwait. The Fund, which is sterling denominated, purchased nursing home properties for the elderly with disabilities throughout the United Kingdom. With longer life expectancies the proportion of elderly people is increasing rapidly and almost 1.7 percent of the population are now aged 85 or over, a proportion projected to increase to over 2.2 percent by 2010. As over one quarter of the population aged 85 or over need to live in nursing homes where they can receive support from qualified nursing and care staff, the demand for such accommodation is increasingly rapidly. There are already over 200,000 private nursing home beds, an increasing proportion

<sup>32</sup> IIBU Student Property Leasing Fund, *Interim Investment Summary*, June 1999, p. 3.

of which are managed by major specialised operators who can meet the legislative requirements and the regulations of the local authorities.

The Funds aim was to achieve a 9.5 percent cash on cash return on investment over a five year fixed maturity period due to end in March 2002.<sup>33</sup> As with the Student Property Leasing Fund additional capital gains are hoped for on disposal of the portfolio of properties. The fund is financed entirely from shareholder subscriptions, and is unleveraged. It is run to comply with the *Shariah*. An underwriting facility is provided to give investors the opportunity to sell their shares every six months, the price being based on an external evaluation of the properties acquired, but subject to a discount which compensates the United Bank of Kuwait for not investing in other similar investments of comparable maturity and risk.

Homes worth £42 million were purchased over the December 1996 to September 1997 period at the costs and locations shown in table 15. The capacity of the homes is 1,110 beds, with occupancy rates around 90 percent.<sup>34</sup> The profit margin per bed has declined from 30 percent in September 1998 to 25 percent by March 1999. The homes have been leased to high quality operators at an annual fixed rental of 11 percent for the first five years. The properties will be disposed off in March 2002 and any capital gains passed on to the investors.

Table 15: Portfolio of Care Homes

<i>Home</i>	<i>Operator</i>	<i>Cost (£)</i>	<i>Location</i>
Lakeside	Tamaris	1,666,700	North East England
Ross Wyld	Tamaris	3,500,000	London
Pear Tree	Tamaris	2,400,000	London
Belmont	Tamaris	3,300,000	South East England
Dormy House	Tamaris	2,350,000	South East England
Lyfords	Tamaris	1,800,000	South East England
Turriff	Tamaris	1,830,000	Scotland
Brechin	Tamaris	1,685,000	Scotland
The Oaks	Speciality Care	1,950,000	North West England
Avondale	Parklands	1,000,000	English Midlands
Deansgate	Parklands	1,650,000	English Midlands
Gowrie House	Four Seasons	2,200,000	Scotland
Henderson House	Four Seasons	2,260,000	Scotland
Craighead	Four Seasons	2,235,000	Scotland
Broadway	Four Seasons	845,000	English Midlands
Beacon Farm	Advantage	1,752,350	North East England
Dolphin View	Advantage	1,212,000	North East England
Willows Court	Advantage	3,338,050	North East England
Rosemount	Advantage	2,060,400	North East England
Albany	Advantage	1,100,000	North East England

Source: IIBU Healthcare Fund, *Investment Summary*, March 1999

By March 1999 informal estimates put the value of the portfolio at over £44.5 million as table 16 shows, a capital gain of over £2.5 million over the period since purchase. The annualised dividend paid has been 10 percent for those

<sup>33</sup> IIBU Healthcare Fund, *Investment Summary*, March 1999, p. 1.

<sup>34</sup> IIBU Healthcare Fund, *Semi Annual Report*, March 1999, p. 3.

investing £1 million or more in the fund, above the projected return, and 9.5 percent for those investing less than £1 million. As the risk free return on United Kingdom government securities has fallen from over 7 percent to less than 5 percent over the period, the return for the modest risk involved has increased significantly.

Table 16: Performance of the IIBU Healthcare Fund

	29/9/98	25/12/98	25/3/99
Net Asset Value	£42,004,800	£44,540,000	£44,540,000
NAV per Share	£100.00	£106.03	£106.03
Annualised dividend yield	10.0%	10.0%	10.0%
5 year UK risk free yield	5.21%	4.54%	4.61%
Margin above risk free	4.79%	5.46%	5.39%

Source: IIBU Healthcare Fund, *Semi Annual Report*, March 1999

#### **11.4 IIBU Biotech Leasing Fund**

Biotechnology has advanced remarkably in recent years, and there are many promising areas for potential business applications and wealth generation. Yet as the controversy over genetically modified crops shows, it is also a very risky area for potential investors if there funds are concentrated in one area of application. To reduce the risks the IIBU Biotech Leasing Fund, which is in the process of being launched, focuses on a range of areas, around half involving therapeutic companies, one quarter in diagnostic companies and a further quarter in medical device and other companies that may include the agricultural sector.<sup>35</sup> The main emphasis is on the human health care sector, rather than animal or plant biotechnology companies.

The fund aims to achieve substantial capital gains, which could bring total returns up to over 14 percent. It is being launched in partnership with a specialist company, Bio-Invest Holdings Inc., which has successfully achieved this financial performance with its two previous funds. The finance is used to purchase non-specialised scientific equipment which is leased to the biotechnology companies with the assets representing the security. The leases are full payout, with no residual value risk on the equipment at the end of a lease. Ten scientific advisors are employed, each an expert in a different field of biotechnology, to review the technical and clinical issues relating to the leased equipment and the lessees.

The fund is dollar denominated, with a target size of \$20 million and a minimum investment of \$200,000. A number of investors have committed funds which will be drawn down in late 1999 and early 2000. The term for the fund is five years, after which the initial subscriptions and any capital gains will be repaid to the investors. Dividends are paid monthly after the first year. There is a one percent entrance fee, and an annual management fee of 1.5 percent per annum, which after the first year is only taken after a minimum 8 percent annual dividend is paid to investors. In addition a custody and administration fee of 0.3 percent per year is levied.

<sup>35</sup> IIBU Biotech Leasing Fund, *Prospectus*, p. 5.

Although clearly it is too early to evaluate the success of this fund, the prospects are promising. In the United States, where the funds are invested, over 153,000 people are employed in the biotechnology industry in 1,200 firms with a market capitalisation approaching \$100 billion. Product sales were worth \$13 billion in 1997, and are projected to rise to \$24 billion by 2006. The more rapid approval procedures for new products by the US Food and Drug Administration has helped the industry, and the alliances between large pharmaceutical firms and the much smaller biotech companies has aided the financial viability of the latter, which are the type of companies leasing equipment through the IIBU scheme. The Fund has been approved by the IIBU's *Shariah* Committee, as both the types of business being funded and the mode of financing comply fully with Islamic law.

### **11.5 IIBU Reality Securities Trust**

Real Estate Investment Trusts (REIT) provide investors with exposure to the property rental market in the United States without the problems involved in property management and sales. The IIBU Fund aims to be the premier REIT fund for Islamic investors, paying dividends derived from property rentals and capital gains from improvements in the value of real estate investments. Davies Selected Advisors, a leading American manager of REITs, advises the fund managers, and *Shariah* advice is provided by IIBU's own advisors. The aim is to provide annualised returns of 10-15 percent after costs and fees have been covered over a 2-3 year period.<sup>36</sup>

The fund is dollar denominated, with a minimum subscription of \$1 million. It was set up on 15th January 1999 as a \$10 million closed fund. The entrance fee was 4 percent, and the management fee 1 percent per annum, with an additional 0.5 percent administrative agent fee per annum. Funds were invested in REITs in four sectors: residential, office, industrial and retail. The Fund deals monthly on the first business day of the month, and by 31st May the adjusted net asset value of the portfolio was \$10,747,251 and the net asset value of each share \$109.74, almost a 10 percent rise since launch.<sup>37</sup> An initial cash payment of 4.57 percent was made on 30th April 1999.

Over a 3 year period prospects for the fund appear promising, as the property rental market in the United States is reasonably priced, and special tax treatment is applied to REITs to encourage this sector. There is no corporate tax on REITs provided 95 percent of income, mainly from rents, is distributed to investors. It is the liquidity, flexibility and transparency of REITs that attracts many investors, and the market is expected to grow by at least 50 percent from its present value of \$150 billion over the next 5 years.

## **12. Conclusion**

Islamic mutual funds are clearly financially viable as the experience of both Fleming's Oasis Fund and the IIBU funds shows, despite disappointment about the success of the former in gaining the confidence of Muslim investors. It is interesting to note that the IIBU funds have attracted substantial

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<sup>36</sup> IIBU Reality Securities Trust, *Prospectus*, p. 3.

<sup>37</sup> IIBU Reality Securities Trust, *Monthly Report*, May 1999.

investment from non-Islamic (conventional) institutions and individuals, which indicates that – independent of religious principles – *Shariah* compliant investments can compete on a commercial risk/return basis. The Islamic mutual fund industry can potentially provide as many different types of fund as the industry more generally, to suit the different preferences and requirements of Muslim investors. The Flemings Fund provided capital growth through investment in major quoted international companies, while the IIBU has aimed to provide a range of enhanced income opportunities by giving Muslim investors the opportunity to invest in a range of real assets in niche markets. Investment in areas such as care for the elderly, medical research and student housing is socially as well as financially worthwhile.

Although the Funds reviewed here are designed primarily for investors of high net worth, other Islamic mutual funds, such as those offered by the banks in Saudi Arabia, and fund management groups in Malaysia, are designed for those with more modest sums to invest. Mutual funds, whether Islamic or conventional, inevitably involve a moderate degree of risk. Muslim savers with limited funds are probably best advised to keep to savings and investment accounts with Islamic banks. For the more affluent mutual funds can be seen as a complement rather than a substitute to savings and investment accounts in Islamic banks. Whereas current accounts with Islamic banks can be regarded as transactions balances, savings and investment accounts can be regarded as precautionary balances. Mutual fund investments are not money holdings however, even on a very broad definition, but rather liquid or quasi-liquid investments which are not suitable for everyone. The introduction of Islamic mutual funds has nevertheless offered Muslim investors more choice, and the opportunity to widen their *Shariah* compliant asset portfolios.