



SHARIAH INVESTING: FAITH MEETING OPPORTUNITIES

Despite the many challenges associated with Shariah investing over the past decade¹, the Islamic approach to investments has seen continued rapid growth in size and product offering since its introduction in the late 1960s in Malaysia.



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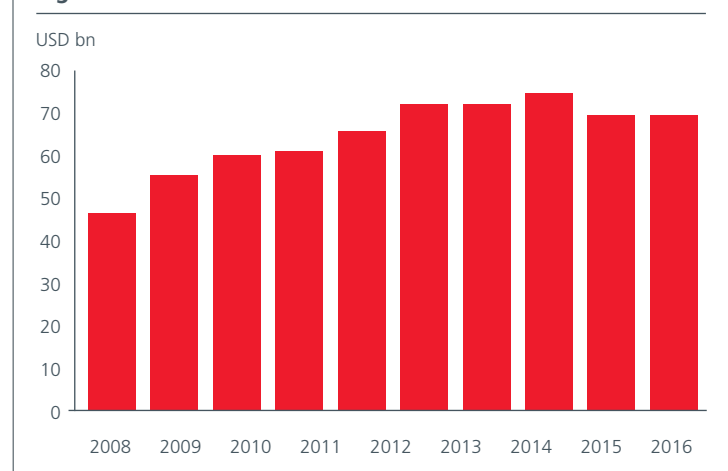
Shariah assets under management are forecast to reach USD77 billion by 2019². This growth trajectory is likely to maintain its momentum as wealth continues to accumulate; investment myths are overcome; strides are made in standardization; and increasing regulatory initiatives provide more transparency and comfort, while continued innovation in Shariah-compliant investment vehicles offer more choices for investors.

AUM GROWTH

The assets under management (AUM) of total global Islamic funds has grown significantly, registering a CAGR of 8.5% from 2004 to 2016. The total number of Shariah funds has also grown rapidly at 14% CAGR from just 285 in 2004 to an estimated 1220 currently³. Malaysia and Saudi Arabia continue to dominate in Shariah investments, where more than two-thirds of these funds are domiciled, whilst the rest are spread out across 35 other jurisdictions. The total size of Islamic AUM is only ever going to

get larger as the inherent demand is overwhelmingly larger than the current size of total Islamic AUM indicates. As the supply side of the equation gets better together with enhanced regulatory structures, many pension and institutional funds will begin to embrace the principle more fully.

Fig. 1: Global Islamic Funds AUM Trend⁴



In Malaysia’s case, the country’s biggest private pension fund, the Employees’ Provident Fund (EPF), introduced its Simpanan Shariah (Shariah Savings) scheme in August 2016 to provide an option for members to convert their conventional EPF account to one that is invested in accordance with Shariah principles. The EPF expects to invest an average of RM25 billion in Shariah assets annually and to allocate a minimum of 45% of its funds to Shariah assets⁵.

At present, it is estimated that close to half of the USD7 trillion in global sovereign wealth funds belong to predominantly Muslim countries. Most of these funds may not yet have specific allocations for Shariah mandates but the coming years will likely see much higher allocations in Islamic assets. Demand for Shariah-compliant assets has never been higher.

DEMOGRAPHICS

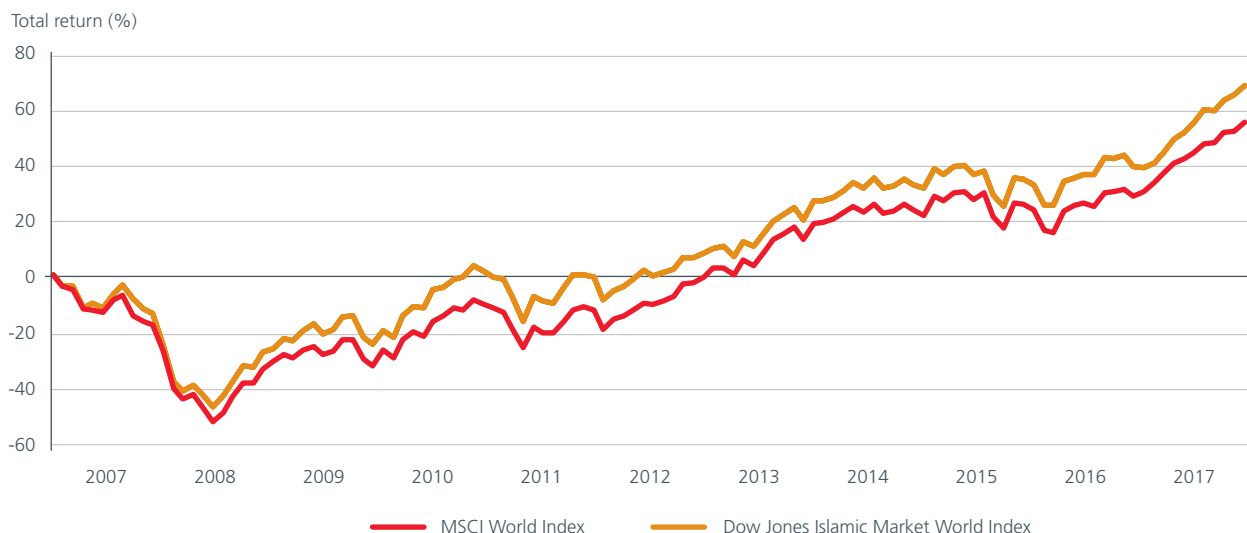
One of the most powerful drivers of Islamic finance has been demographics. Muslims represent nearly a quarter of the world’s population but probably less than 5% of financial assets are Shariah-compliant. Income per capita of predominantly Muslim nations, outside of GCC countries, are still relatively low but are nevertheless growing at a

strong rate. Although the historical heartland of Islam is the Middle East, the region only accounts for 20% of the global Muslim population. More than two-thirds of Muslims are in the Asia-Pacific region, predominantly in the Indian subcontinent and Southeast Asia, and the demographics there have impressive strong growth dynamics. On average, gross domestic product of the member countries of the Organisation of Islamic Cooperation (OIC) is estimated to grow at nearly twice the rate of the global average.

CHALLENGES

Shariah investing has come a long way since the early 1990s. One of the challenges of this investment principle has been the perceived lack of investment opportunities and financial assets as well as poorer fund performances compared to its conventional cousins. However, the global financial crisis of 2008/09, where sub-prime credit wreaked havoc in financial institutions, was like a coming of age for Shariah-compliant equity funds. The Dow Jones Islamic Market World Index is still hanging on to its outperformance over the MSCI World Index over a ten-year period (2007-2017). A significant contributor of outperformance is not just down to the absence of banks and financial institutions,

Fig. 2: 10-year DJI World vs MSCI World⁶



but also the fact that screening procedures largely exclude highly leveraged companies. This represented a strategy that worked extremely well especially in a low growth environment.

One of the other key challenges with Shariah investing is the availability of Shariah-compliant financial assets. On the supply side, the growth of the sukuk market has been an important factor in the overall growth of Islamic finance. The sukuk market has grown rapidly over the past 15 years, expanding at a CAGR of 20%. Total Malaysia-domiciled sukuk outstanding valued at USD174.4 billion makes up 54% of total global sukuk outstanding as at end 2015⁷. Increasingly more corporates are contemplating issuing sukuk rather than conventional bonds as they can tap into the liquidity pool of Shariah funds and Islamic banks.

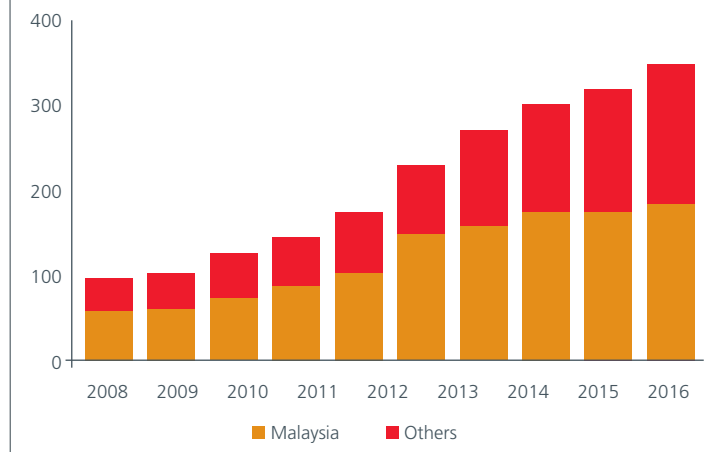
Other challenges include fees⁸ and governance. Shariah funds are currently more expensive to manage, requiring a board of Islamic scholars to perform an audit each year while also holding responsibility for supervision of the fund. Portfolio managers must screen investments carefully to ensure they are compliant, and ringfence and redirect any non-compliant income to charity.

MARKET DEVELOPMENT

Malaysia has always positioned itself as the leading global Islamic financial centre and the government has been supportive with initiatives led by the regulators. To enhance its value proposition as a global Islamic finance hub, the Securities Commission is advocating several key strategies such as tapping the synergies between Shariah investments and socially responsible investments, developing new products such as private equity, setting up multi-currency funds and promoting cross border transactions.

Continued product innovation, we believe, will be key to the development of the Islamic finance markets by adding depth to the availability of Shariah-compliant securities and products. One of the key developments to watch out for in this space will be initiatives such as that of Permodalan Nasional Berhad (PNB), the shareholder of

Fig. 3: Global Sukuk Outstanding (US\$bn)⁹



Malaysia's largest banking group, to carve out 20% of Maybank shares into Islamic or i-shares through a ring-fencing mechanism. If successful, this can access billions in value of a previously closed sector and truly widen the investment opportunities for Shariah funds.

Eastspring Investments Berhad and Eastspring Al-Wara' Investments Berhad manage a total of USD1.64 billion in Shariah-compliant assets in Malaysia, including money market, bond, equity and multi asset funds, as well as an Islamic small cap fund.

Sources: ¹Shariah-Compliant Funds. Shariah-compliant funds are investment funds which meet the requirements of Shariah law and the principles articulated for "Islamic finance." Shariah-compliant funds must follow a variety of rules, including investing only in Shariah-compliant companies, appointing a Shariah board, carrying out an annual Shariah audit and purifying certain prohibited types of income, such as interest, by donating them to a charity. Shariah-compliant funds are prohibited from investing in companies which derive income from the sales of alcohol, pork products, pornography, gambling, military equipment or weapons. Shariah allows for a small portion of an investment's income to come from prohibited sources, though a Shariah-compliant fund cannot profit from this income. Instead, it must separately account for these earnings and donate them to a charity. ²Thomson Reuters, Global Islamic Asset Management Outlook. ³IFSB, Islamic Financial Services Industry Stability Report 2016. ⁴IFSB Islamic Financial Services Industry Stability Report 2016. ⁵The Employees Provident Fund, 17 January 2017 statement release. ⁶Bloomberg. ⁷Securities Commission Malaysia, Islamic Fund And Wealth Management Blueprint. ⁸<https://www.ft.com/content/8dd627c8-01c9-11e4-ab5b-00144feab7de?mhq5j=e5>. ⁹Thomson Reuters, MIFC.

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