

Even Islamic funds have been impacted by the crisis

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In spite of their conservative investment principles, Islamic funds could not avoid the general hysteria that has infected financial markets.



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The Islamic financial industry has experienced a tremendous boom in the last five years, boasting growth rates of 20–30% per annum. The number of Islamic funds has increased from approximately 200 funds in 2003 to over 650 funds in 2008. Factors including the rising oil prices that created excess liquidity in the oil-rich Islamic countries, and a rise in Islamic fundamentalism and political views, have driven the upsurge. The crash of the international markets in 2007, which started in the finance sector – a sector prohibited to Islamic investors and funds – also boosted the popularity of Islamic funds.

Islamic funds are governed by Shariah law. These are the fundamental principles that govern all aspects of a Muslim's life, including finances. The core principles, which are not considerably different from other major religions, are based on integrity, sincerity, honesty and fair treatment.

Shariah law prohibits Islamic funds from investing in companies whose predominant operations are considered 'haram' or unlawful. These include companies that produce, sell or distribute alcoholic products, pork and pork-related products or tobacco; companies engaging in gambling or entertainment; companies producing weapons; and any conventional financial institutions, including banks and insurance companies. Investments are limited to companies considered to have healthy capital structures. Consequently, companies with debt to market capitalisation ratios exceeding 33%, whose cash and other deposits exceed 33%, or whose receivables as a percentage of market capitalisation exceeds 45%, are prohibited (note these ratios are judgmental and may vary depending on the Shariah board of the fund).

The most significant prohibitions in Islamic finance are: (i) the earning of 'riba', known conventionally as interest; and (ii) 'gharar', which is speculation. These exclusions have prevented Islamic funds from investing in fixed income, hedge funds and derivatives. Each of these areas was hit hard by the credit crunch and ensuing market crisis, which has led people to conclude that Islamic funds have been insulated from the crisis. This belief has been flaunted by many Islamic financiers, and in reality is a slight exaggeration.

Slight performance advantages

Comparing the 2008 MSCI World index with that of the MSCI Islamic World Index one can see that both markets were severely hit in the past year with returns of negative 42% and 36% respectively.

While Islamic equity market indices, in general, did not include the badly hit banking and financial sectors, they have not been completely immune to the overall equity market volatility. The fourth quarter of 2008 was exceptionally hard on all markets, including the Islamic markets, and eliminated some of the advantage Islamic indices had over conventional indices.



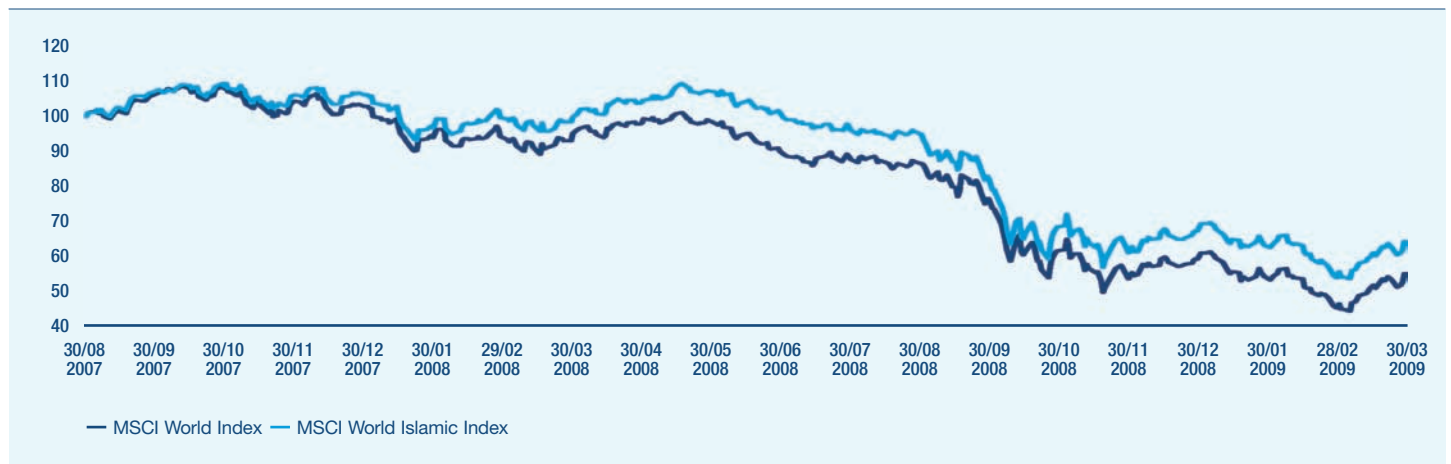
Contributing factors

Some of the factors that have contributed to the success of Islamic funds are in response to the conservative nature of Islamic investing – avoiding leverage, speculation and companies carrying excessive debt. Nevertheless, the Islamic markets have not been completely protected from the general market deterioration. Their heavy weightings in real estate and commodities, which have also suffered severely in the

past year, have triggered significant negative returns.

While it is true that the Islamic markets have fared better than others through the turmoil, the crisis has left nothing unscathed. Islamic funds have benefited from their conservative principles and have avoided the losses created by over-leveraging. Unfortunately, they have not been immune to the general hysteria and lack of confidence that has impacted the equity markets, and have still suffered significantly.

MSCI World Index vs. MSCI World Islamic Index



Global Asset Management contacts

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