

Innovators in Islamic finance

Innovation is the key to growth in the Islamic finance industry. Eric Meyer, president and CEO of Shariah Capital and Sheikh Yusuf Talal DeLorenzo, Shari'ah consultant spoke to Paul McNamara about some pioneering new innovations of their own.

Readers of Banker Middle East will already be familiar with Eric Meyer, considered a pioneer in Islamic finance. Since leaving his successful US-based hedge fund in 2000 to concentrate full time on Shari'ah compliant investment solutions, Eric has devoted nearly all of the last four years (and over \$3 million of his own money) to bring together, in a variety of Shari'ah compliant formats, the best investment managers in the west to Islamic investors.

Sheikh Yusuf Talal DeLorenzo is another figure who needs little introduction as one of the handful of globally respected Shari'ah scholars. Sheikh Yusuf bases himself outside of Washington, D.C. where he writes and researches projects related to Islamic finance and consults with firms around the world on issues of Shari'ah compliance.

You have collaborated in the past on the development of innovative Islamic financial tools and I understand that you are no hosting an Islamic finance conference in New York?

Sh Yusuf: Yes, we are. New York has always been a centre for financial innovation. In my opinion, it is only natural that New York is already becoming a leading centre of Islamic financial innovation as well.

EM: We hope to demonstrate that the west is ready to embrace Islamic finance; whether on its own terms or as a subset of socially responsible investing. At the same time, we are going to showcase the marketing launch of our two funds of hedge funds: Shari'ah Long/Short Master Fund and Shari'ah Market Neutral Master Fund.

This conference is aimed at the large number of financial institutions and money managers located in New York?

Sh. Yusuf: Yes, but this is not just a conference for New York. It is a global conference. Islamic innovation generates interest from around the world.

EM: We already have confirmed sponsors from the Gulf and Asia.

Sh Yusuf: The approach of this conference is very different. That's because this conference is essentially a forum for introducing Islamic finance for US-based firms, many of which are faced with increasing demands from their clients and investors for Shari'ah-compliance in their dealings and investments. Our intention at the conference is to showcase how financial and investment professionals are developing solutions for dealing with such demands. At the same time, we hope to bring in many of the Islamic investors themselves, so that they may see, first hand, how the best in the business, so to speak, are responding to increasing demands for Shari'ah compliance.



Eric Meyer

Eric, turning to your funds, I understand you've devised a way for Islamic investors to invest in conventional hedge funds, despite the Shari'ah restriction against short selling?

EM: Our Shari'ah advisors, Sheikh Nizam Yaquby, Sheikh Yusuf Talal DeLorenzo and Dr. Daud Bakar deserve much of the credit here. Without their willingness to work with me for a number of years, learning the intricacies of prime broker documentation and the details of margin requirements and short selling, I would never have been able to devise the solutions that now bridge the differences between Shari'ah and conventional finance.

Let me be clear. Our hedge fund managers do not short stocks in the conventional sense. They do not borrow shares from a bank or broker and sell them in the market in the hope of buying them back later at a lower price. Instead, we have created an instrument that a conventional hedge fund manager buys when he wants to short a stock. This instrument is not a conventional short position. But it replicates the economics of a short sale.

So, when a hedge fund manager wants to short IBM, for example, his trader puts through the same order to his prime broker that he would normally place for a conventional portfolio. The difference is that Shari'ah Capital, working with Barclays Capital, our prime broker, facilitates the transaction as a purchase

– without any impact on the hedge fund manager or his portfolio. The result is that conventional hedge fund managers, using the tools that we have created, can manage on a Shari’ah compliant basis without changing their investment styles.

Sh. Yusuf: This development really breaks new ground for Islamic investors. It opens up an entirely new asset class for Islamic investors; and this is especially important when viewed against the limited set of risk management tools presently available in Shari’ah compliant form to Islamic investors, including the treasuries of our Islamic banks themselves.

Your short sale solution is Arboon-based. What were the challenges that you faced here? You had to modify prime broker documents as part of this process?

EM: Yes. Originally, we spent close to a year pursuing a short sale solution utilising a Salaam sale. While we could get a Salaam sale to replicate a conventional short sale in theory, we could not get a Salaam sale to replicate a hedge fund manager’s prime broker margin or balance sheet. Based on my experience as a hedge fund manager, I did not believe leading hedge funds or prime brokers would be interested in operating with a margin or balance sheet that was different from the way they currently run their portfolios. So, for these reasons, we shifted our focus to an Arboon-based solution. The significance of the Arboon solution that we created is that it worked comfortably within industry standards for margin accounts and hedge fund managers’ balance sheets.

This breakthrough allowed us to approach ‘best of breed’ hedge fund managers and prime brokers without asking them to deviate from a standard practice that they understood. However, this solution did require a wholesale modification of prime broker documents. At the same time, our Shari’ah scholars had to sign off on every step of the prime broker document modifications in order for our funds to have direct fatwa certification. Needless to say, the process was incredibly time-consuming and expensive.

So Muslim investors really get the same hedge fund managers as a conventional investor?

EM: Exactly. That was one of the early conditions of our Shari’ah scholars: give Islamic investors a level playing field with conventional hedge fund investors. We’ve done that. And, more importantly, we’ve been able to attract ‘best of breed’ hedge fund managers into our fund of funds. These managers were intrigued to diversify their client bases by including Islamic investors. Until now, they did not have the methodologies to comply with Shari’ah so they did not have a product to attract these clients. Now they do.

Do your tools work with all hedge fund managers and strategies?

EM: No. We are not there yet. At this point, our tools and structures can only accommodate long/short and market neutral equity hedge fund managers. There remains much more work to be done with Shari’ah scholars and western legal and financial



Sheikh Yusuf Talal DeLorenzo

experts to accommodate strategies like fixed income, convertible arbitrage, global macro and other hedge fund strategies. I am confident that it will happen over time. However, it was important to me, and to our Shari’ah scholars, to launch our funds as soon as practical, without waiting until we could accommodate the entire range of hedge fund strategies.

You certainly have faced a number of obstacles. What is the status of your funds today?

EM: When Bank of America pulled out as our prime broker because of internal issues earlier this year, we were forced to postpone our January launch. We had to withdraw our offering memorandum and return money already in escrow. It was a very difficult period. But as Sheikh Nizam Yaquby counselled me with a quote from the Quran: “It may be that you will dislike something, when in fact it is actually good for you.”

Barclays immediately understood our business opportunities and committed resources to work with us. They have been wonderfully supportive. They have worked tirelessly with our scholars and our US legal counsel to get things back on track. I am happy to report that our Shari’ah Long/Short Master Fund and our Shari’ah Market Neutral Fund shortly will be ready for re-launch. We are actively looking for core investors for both funds.

Not to take anything away from your dedication and perseverance, but why haven’t others tried to build a Shari’ah compliant fund of hedge funds using conventional hedge fund managers?

EM: I am sure they have. We are seeing Shari’ah compliant single strategy hedge funds starting to market or launch, although they all seem to differ from us by using a Salaam-based methodology rather than an Arboon. Three years ago, Sukuk were a novelty. Today, they are a legitimate investment class. Shari’ah compliant hedge funds and funds of funds, I believe, will follow the same

course. We are still in the early stages, but I predict that Shari'ah compliant hedge funds will soon be widely accepted by Islamic individual and institutional investors. The reason we don't see more firms dedicating the time and resources is because, quite simply, it is a lot of work that costs a significant amount of money. It requires serious critical thinkers who are committed to overcoming difficult issues. You know, when corporate management looks at a particular project, they give it a budget and a timeline. That doesn't work here. In my case, I continued regardless of cost and timelines. I don't give up easily. I believe passionately in what we've built and I've invested my personal wealth to prove it.

How do you know that there is investor demand?

EM: Well, with the booming equity markets today in the Gulf, our consistent, 'tahawwut'-like returns may be temporarily overshadowed. Our projected 10-15% returns in the Long/Short Master Fund can't compare to those of the local stock markets for the last several years. But, in May, I spoke at a conference in Bahrain. In the course of the conference, delegates were asked what their most important investment issues were. Out of 32 issues, the number one concern was how to hedge Islamic assets against capital loss. That survey tells me that Islamic investors recognise the potential volatility in local markets. It shows their foresight in looking now for ways to weather market downturns. Hedge funds, by definition, look to mitigate risk and reduce market volatility. So, I think we are getting there.

I understand your Market Neutral fund actually projects a higher return than comparable Murabaha rates while potentially offering similar features like principal protection and liquidity?

EM: That's right. We built our Shari'ah compliant market neutral fund purposely to compete with low Murabaha yields. We have found first class managers who can generate net returns nearly double those from Murabaha investments – and offer monthly liquidity. We could even add a customised principal-protection feature. So, to that extent, yes, our market neutral fund of funds is very competitive with local instruments. It is ideal for bank treasuries and portfolio managers who need to place short-term funds on a Shari'ah compliant basis. We believe this fund will become a viable alternative for funds that today are invested passively in Murabaha. If we can deliver a 200-300 basis point differential over Murabaha with nominal standard deviation, the gains for bank treasuries and managed portfolios will be significant.

How do you screen stocks for Shari'ah compliance? Hedge fund managers typically need a broad and diverse universe of companies to execute their strategies. It seems to many of our readers that there aren't enough 'Shari'ah eligible' companies traded on the major international exchanges for a conventional hedge fund manager to run a diversified portfolio.

Sh.Yusuf: They're right. The well-known Islamic market indices qualify only around 600 companies in the US market, for example. That's not enough for a hedge fund manager. What

my Shari'ah colleagues and Eric did early on was to look closely at current Shari'ah criteria. The first criteria, announced in 1999, represented a good first step. But it needed refining, and we were aware of that even then.

For example, after screening at the primary business level, early criteria looked at company financials. In doing so, it focused on indicators of prohibited financial activity, like interest, rather than on the activity itself. For example, if a company is flush with cash, the indicator, then the assumption is that the company cannot be an acceptable Islamic investment because the cash will be earning interest. The same sort of assumption is made when the data indicates high levels of debt financing or leverage. Early on, the screens looked at the ratio of a company's debt to its total assets. This was changed by some to measure debt to market capitalisation. But the important thing is that debt, in and of itself, is not haram (prohibited). It is the interest that is prohibited; and the interest component determines whether or not a company is compliant. The refinements involve delving into a company's balance sheet accurately and efficiently and finding interest paid and interest received as line items that can be analysed and screened for compliance.

How did you do that? You can't have an army of analysts poring over annual reports?

EM: Absolutely not. To look at corporate balance sheets manually was not practical, owing to the high possibility of human error. Instead, we turned to technology. My background, going back to my venture capital days, is computer software. Every publicly traded company in the US is required by law to file its financial statements electronically. This reporting system, known as EDGAR, was instituted in the late 1990s. In 2002, software experts and I designed a system to process corporate financial data as soon as it is reported on EDGAR and disseminated to service providers like S&P, the firm we work with today. We download the data from S&P, run it through our screens, and calculate the various ratios, and update our compliance database automatically. Today's technology enables us to screen thousands of companies in seconds. It's really remarkable. In fact, I'll be demonstrating our screens at our conference in New York on September 8th as well as at the Islamic Funds World conference in Dubai on September 14th.

So how do your refined screens qualify more companies as Shari'ah compliant? Are your criteria more liberal with their Shari'ah standards?

Sh Yusuf: More liberal? Not at all. The refined criteria are actually stricter. Let me explain. The solution developed by our Shari'ah board uses screening criteria that is stricter from a Shari'ah perspective than the original, 1999 criteria, and yet at the same time results in a far larger universe of eligible securities. This seeming contradiction is easily explained by two factors. Firstly, the original criteria was developed before the deployment of the SEC's EDGAR database for electronic filing and, secondly, the screening criteria was focused not on interest itself, but on the broadest indicators of interest, things

like debt, and cash and cash-equivalent holdings (because these earn interest). The reason for the increased universe yielded by the screens we developed is that the screens are far more efficient; and that is why they are at one and the same time both more conservative and more expansive.

That's the paradox. When we applied more exacting Shari'ah criteria against corporate balance sheets and drilled down on line items like interest, we found that many more companies were Shari'ah compliant than the popular Islamic indices indicated.

For example, a while ago Apple Computer carried a sizeable cash position relative to its market cap. Existing Islamic indexes disqualified it for consideration by Islamic investors. Why? Because the cash relative to the market cap was excessive, indicating a high level of interest income from cash and cash equivalents. When we looked closer, of course, we realised that with interest rates at a 35 year low at the time, Apple's interest income was in fact so miniscule, relative to the market cap at the time, as to be negligible; and there was no basis to disqualify it for consideration by Shari'ah compliant investors.

In the end, we found nearly 5500 publicly-traded US companies that met the standards for Shari'ah compliance, more than 10 times the number of companies under the 1999 guidelines. Of course, markets move, and numbers change. But generally speaking, the larger number of Shari'ah compliant companies enables more hedge fund managers to pursue their investment strategies with only minor adjustments. The more managers who manage Shari'ah compliant, of course, the wider the pool for Eric to choose from in structuring a diversified fund of funds.

What is the biggest challenge for a hedge fund manager who wants to manage Shari'ah compliantly?

EM: With our tools and processes, it's not the mechanics. Generally, for us, it's been that banks and insurance companies represent too large a portion of a hedge fund manager's overall portfolio. Financial stocks represent over 22% of the S&P. Understandably, many hedge fund managers will have exposure to these companies, particularly the large cap banks like Citigroup and JPMorgan Chase. These types of companies, of course, are not Shari'ah compliant. So, we don't pursue our due diligence process with managers who invest heavily in bank and insurance companies, or such areas like gaming and casino stocks.

Instead, we focus on hedge funds that specialise in areas like health care and technology or in sections of the economy like consumer goods and basic industries. There are many excellent hedge fund managers in these areas. As a result, we have been able to put together a world-class group of managers with consistently competitive performance. We are confident that, while managing Shari'ah compliant, these managers will continue to outperform their industry colleagues.

Why would a successful hedge fund manager with good performance want to manage funds under the special conditions of Shari'ah compliance?

EM: That's an excellent question and one that scared me when I first approached managers. To my surprise, we have had an overwhelmingly positive response from long/short and market neutral managers who want to be included for consideration in our program. The reason: Islamic investors represent a true diversification of their client bases. Most successful US hedge fund managers see money inflows from pension funds or endowments or family offices. They would like to have a more broadly diversified base of clients in case one of the above groups changes strategy and redeems. As one manager remarked to me: "Islamic investors, as a client segment, do not correlate to my other clients. They have a reputation for being long-term investors. So, in a sense, they help me balance my asset exposure to US domestic pension funds." Spoken like a true hedge fund manager!

Let's talk about risk. Hedge funds have a reputation for being risky. How do you mitigate the market's perceived risks with hedge funds?

EM: 'Tools with rules' is a theme I spoke about in Bahrain. Hedging techniques are great tools for preserving capital and delivering consistent, absolute returns regardless of market movements – the primary purpose of hedging. The Arabic word for hedging, 'tahawwut', in fact, describes a conservative, prudent approach to the market. Unless there are rules like limits to leverage, for example, things can get out of hand very quickly.

Sh.Yusuf: And let me add that the Shari'ah guidelines for Eric's underlying hedge fund managers require that they screen and we monitor their portfolios and transactions every day. For that reason, managers are required to establish a separately managed account at our designated prime broker. The separately-managed account lends transparency to the manager's portfolio. So, while the Shari'ah board monitors the portfolio for Shari'ah compliance, Eric can watch for early warning signals, such as position concentration, uncharacteristic long/short exposure, style drift and other manager pitfalls. In effect, the transparency required for Shari'ah compliance allows us to employ better risk management than funds of funds that simply invest in a manager's offshore fund. The fund of funds manager there only gets a quarterly report on the portfolio. In our case, we have access to every trade, every day. That level of enhanced risk management is an important benefit to Islamic investors.

EM: Also, effective from February 2006, all hedge fund managers in the US must be registered with the US Securities and Exchange Commission. That includes Shariah Capital and Meyer Fund Management. I think this is a very positive development. Not only will it help our internal due diligence process with managers, it also will ease the concerns of offshore investors who mistakenly perceive hedge funds as aggressive and unregulated. The industry is moving in the right direction. Islamic investors can invest with the assurance that regulatory and industry standards are in place to protect their interests. I think hedge fund managers, investors, and fund of funds managers like us all will benefit from this development. ■