

SHARI'AH COMPLIANT HEDGE FUNDS: NOW WITH PRINCIPAL PROTECTION

Recently we interviewed Eric Meyer, president and CEO of Shariah Capital about the marketing launch of his Shariah Long/Short Master Fund, Ltd. and Shariah Market Neutral Master Fund, Ltd., the first Shari'ah compliant funds of hedge funds in the market. Here Paul McNamara talks to one of the core hedge fund managers in his market neutral fund, **Tim Krochuk** of **GRT Capital Partners**

GRT Capital Partners manages primarily long/short, market neutral and sector-based investment funds. Founded in Boston in 2001, the firm is a registered investment adviser with over \$500 million under management.

Principals Tim Krochuk and Greg Fraser managed previously at Fidelity Investments. Tim ran the Fidelity TechnoQuant Growth Funds and the Fidelity Small Cap Selector Fund. Greg ran the Fidelity Diversified International Fund. Together, along with four other members of the group, they were responsible for over \$30 billion at Fidelity. A third principal, Rudy Kluiber, managed at State Street Research where he ran the State Street Research Aurora Fund, a small cap value mutual fund. All three are graduates of Harvard College.

Here Tim Krochuk talks about how, utilising the screens and methodologies devised by Eric Meyer and Shariah Capital, GRT is able to deliver a Shari'ah compliant hedge fund product based upon his firm's market neutral strategies and a unique principal protection feature.

GRT is known for its quantitative approach to the market. A lot of people tune out when you say 'quant strategies'. They have no idea about what you do. How do you respond to that?

It's a question I get all the time. A quantitative approach to the market is not just 100,000 lines of computer code. Quantitative models, in fact, spell out exactly why we should or should not own a stock. They give clarity to our stock selections and discipline to our process. This discipline helps us build returns. It also helps protect against risk.

At GRT, we are different from the stereotypical quant manager, if there is such a thing. None of us are Ph.D 'geeks'. We are

experienced market traders and stock pickers, well-grounded in the fundamentals of stock research. Unlike some quant managers, we regularly meet companies and their management. Contrary to some thinking, we do not rely strictly on a computer model to buy and sell stocks. Investment decisions at GRT are made by a real person. Ultimately, our quantitative models are only tools that help our decision-making.

Why did you decide to link up with Shariah Capital?

We've known Eric Meyer and his team since they approached us to become a manager in their Shariah Market Neutral Master Fund, Ltd. We also thought it was prudent to diversify our client base beyond the institutional and pension money we manage currently. And, quite honestly, the idea of managing within Shari'ah was intellectually intriguing. For us, Shari'ah is another model for creating a portfolio.

In the end, I suppose we just were comfortable with Shariah Capital's expertise and infrastructure. Their Shari'ah process for

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Tim Krochuk, of GRT Capital Partners

hedge fund managers is easier than anything else we've seen in the market.

How are you able to manage your market neutral hedge fund strategies with Shari'ah compliant guidelines?

In two ways. First, quantitative hedge fund strategies can accommodate most industry sectors. Banks and financial institutions are the exception. It is difficult to assess the quality of a bank's loan portfolio simply from its financial statements. It requires research skills different from those of most quantitative managers. As a result, at GRT we generally don't include bank or insurance company stocks in our portfolios.

As it turns out, coincidentally, bank and insurance stocks, nearly 22% of the S&P 500, are prohibited under Shari'ah. That's a problem for many hedge fund managers. It's not a problem for GRT, however, since these companies usually aren't included in our models anyway. With the exception of a few gaming companies, the balance of the 80-100 names in our portfolios fit comfortably within Shari'ah guidelines. So, our strategies already are pretty much Shari'ah compliant in their current form.

The second reason is the screening process designed by Eric Meyer at Shariah Capital. It is fast, efficient, and easy for us to use. Since it is Web-based, I can download an Excel spreadsheet of companies and know in a matter of seconds which stocks I can include in my investment universe. After that, I manage the same way I manage my conventional hedge fund accounts.

Interestingly, we discovered in back tests that Shari'ah dramatically improves our overall returns. For example, for the five-year period from January 2000 to June 2005, performance increased by more than 60% when we applied Shari'ah criteria.

You see, Shari'ah effectively screens out companies with high levels of debt and forces a portfolio manager to consider companies with strong cash flows, not unlike Warren Buffet's approach. So,

believe it or not, GRT already follows some Shari'ah criteria in our conventional hedge fund models! In effect, we are using Shari'ah criteria today as part of our normal portfolio management process, for the benefit of all of our investor clients.

What about the short sales?

Shariah Capital, working with Barclays, its prime broker, has solved that problem. We just concentrate on building our models and generating returns.

So, what is your market neutral strategy?

We have two of them, actually. One is based on trading pairs of long and short stock positions that, together, minimise the overall portfolio's exposure to the market or to a specific market sector. For example, we might be long on General Motors because we think the price of that stock will go up; we might pair that position against Ford where we think the stock price will go down.

We use a series of quantitative models, based upon such criteria as valuation, price momentum and so on to construct a pool of stock pairs that effectively are non-correlated to the broader market. The result is a portfolio with very low risk and modest, but consistent, returns. Our target for this strategy is to exceed the risk-free rate of return, net of fees.

Our second strategy is more aggressive. The total dollar amount of the long and short positions in this portfolio are weighted equally. So, we might have \$50 million in long positions and \$50 million in short positions. We try to buy the 'best of the best' stocks and short

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the 'worst of the worst' in this strategy. This portfolio will experience more market volatility, but we expect to see annual returns well above those of the market. We will accept market volatility in exchange for the prospect of substantially higher returns.

For our new product, we will use a combination of these two market neutral strategies to target an 8%+ annual return.

Can you tell us about your new product with Shariah Capital?

Based upon our experience managing through quantitative models over the last 17 years, plus the extensive back-testing we have undertaken over the last few months, my GRT partners and I believe that a combination of our market neutral strategies can deliver above-market annual returns over a three-year investment cycle.

More importantly, we believe that we can minimise losses. In both good markets and difficult markets, our market neutral strategies have declined only slightly in any one month. For your readers familiar with hedge funds, our downside deviation for the market neutral strategy is only 0.65%.

Our product proposes to raise an initial amount of around



Eric Meyer, president and CEO of Shariah Capital and long time champion of the Islamic hedge fund

\$100 million, all of which will be invested in GRT's market neutral strategies and managed within Shari'ah compliant guidelines. We expect to do better than Murabaha rates, which currently are below 5%.

You're going to target a Shari'ah compliant minimum return higher than current Murabaha rates and protect principal?

That's our goal. In direct competition with Murabaha instruments. Our objective is to win the cash management business from institutions and investment managers with Shari'ah compliant mandates that are under performing as a result of low Murabaha rates.

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How will an investor's principal be protected?

In the past, principal protection has meant a bank guaranteed note, or some similar structure. With the various bank fees, that arrangement was very expensive. It cost investors a healthy portion of their returns. We want to eliminate those extra fees and give as much return to investors as possible.

Any investor likes volatility when the market is going up. He

likes markets that are up 20% + in a given year. Who doesn't? What he wants, however, is protection against downside volatility. Certainly, he wants to protect himself against short, dramatic market declines, perhaps because of exogenous political or economic events outside of the market. He also wants protection against a market without direction, or one trending downward. That's where we historically have added value.

We know the holdings in our portfolios. We have a very good idea about how they will react in choppy markets. In our Shari'ah back-test, and with our live returns, our risk management processes worked remarkably well, particularly during the difficult 2000-2002 period. They confirm our capability to reduce downside volatility.

So, we will concentrate specifically on controlling downside volatility in order to offer a principal protection feature with our product.

If you are not going to use a note from a bank to protect principal, what will you use?

We are going to use two things: outside capital and a rigorous, independent monitoring system.

In the chart I have shown you, you'll see the category 'Independent Capital - \$5 million.' This amount represents a separate group willing to protect

the investors' \$100 million of assets for the opportunity to earn venture capital-type returns. We estimate that these independent sources can realise significant returns on their capital over a three year period.

The \$100 million of investment assets will be held in a custody account at Barclays, New York. We expect that Custom House, Dublin will be the fund's administrator.

If our performance in any one month is negative, Custom House will withdraw the amount necessary from the Independent Capital to bring the investors' balance back to \$100 million. In the highly unlikely event that the fund sustains monthly losses that erode the Independent Capital, all trading would be halted. The entire portfolio then would be liquidated, the investors' assets returned and the account closed.

So, the Independent Capital of \$5 million really serves as a buffer against principal risk?

Exactly. The fund investors' assets are protected by the Independent Capital.

Now, don't forget, when there are positive returns, the investors' \$100 million will increase in value. For example, let's assume that the fund's first 3 months are positive and the fund value is up to \$102 million. Then, assume that in the 4th month, the fund is down 0.3%. At that point, there is no need to tap the Independent Capital since the total fund value remains above \$100 million. The Independent Capital will only be tapped if the fund value falls below

SHARI'AH COMPLIANT PRINCIPAL PROTECTED FUND THREE YEAR FINANCIALS HYPOTHETICAL ILLUSTRATION

	Initial Investment	Year 1	Year 2	Year 3
Hypothetical Fund Return		8.0%	8.0%	8.0%
Investors Minimum Return		5.0%	5.0%	5.0%
Fund Balance	100,000,000	108,000,000	113,670,000	119,353,500
Investors Balance	100,000,000	105,000,000	110,250,000	115,762,500
Excess Capital		3,000,000	3,420,000	3,591,000
Annual Protection (%)		5%	5%	5%
Annual Protection (\$)	5,000,000	5,250,000	5,512,500	5,788,125
Independent Capital Investment	5,000,000	8,000,000	11,420,000	15,011,000
Independent Capital Receipts		2,750,000	3,157,500	3,315,375
Return of Independent Capital		55.00%	63.15%	63.15%

Independent Capital Economics	
Total Investment	5,000,000
Total Return at End of Three Years	15,011,000
Three Year Return	200.22%

The Performance shown is hypothetical and not based on actual results. The performance is based on a "backtest" of a theoretical model. The model was developed from historical data for a sample period of time and then applied retroactively to a longer period of data to create simulated performance results.

\$100 million. Over time, as the value of the portfolio increases, the need for Independent Capital decreases.

What investor would take the risk of losing his \$5 million of Independent Capital if you don't perform?

That's easy. Those who want the opportunity to make a significant return on their money. Throughout the world, there are many venture capitalists, investment firms and private investors with a higher tolerance for risk. Shariah Capital will be meeting these investors and working out the details with them. From our side, we will give these independent sources full transparency to the portfolio: they will be able to monitor our investment strategy and see exactly how the portfolio is being invested every day.

Investors who put in the \$100 million of assets participate in a Shari'ah compliant product, with a unique principal protection feature, that targets a minimum return per year competitive with today's Murabaha rates.

Those who put up the Independent Capital also are generously rewarded. They could earn a sizeable return for supporting a very low volatility investment model that historically has shown consistently positive, absolute returns. At the same time, their money, and the portfolio, is always subject to Barclays' custody

The Shari'ah and principal protection features notwithstanding, the success of your fund, in the end, still comes down to your performance. Why are you confident that your fund will earn better than market returns

Our experience and our pedigree. In August, Bob Kuo, another member of our old quant group at Fidelity, joined GRT. Bob was the third member of our 4-man team at Fidelity, along with Greg Fraser and myself. The fourth member, Brad Lewis, has retired, although we communicate with him often about ideas and strategies.

So, we have transplanted much of the quantitative team that managed more than \$30 billion for over 15 years at Fidelity to our shop. We've worked together successfully for many years delivering exceptional returns to Fidelity's clients using our strategies. We have every confidence that we can do the same for Shari'ah compliant investors in this new product.

Do you have a timeline for the fund?

I am coming back to the Gulf in early December to speak at the Hedge Fund Investment Summit in Dubai. After that, Shariah Capital is arranging for me to meet a number of individuals and institutions. From what I hear, there is genuine demand for Murabaha alternatives. I'm excited to bring a fund that I think solves the problem.