Islamic Investment Funds as means for resource mobilization

By:
Dr. Mohamed A. Elgari Bineid
Associate Professor of Economics,
King Abdulaziz University, Jeddah

بسم الله الرحمن الرحيم

Introduction:

The history of economic development, in the now industrialized countries, is a story of "saving schemes". Every "success story" in economic growth conceal an achievement in improving the national saving rate.

Even on theoretical basis, theories of economic development are designs for squeezing the most savings out of the traditional sector into investment in the formal one, and making sure that improvement in productivity and income will not get absorbed by an increase rate of consumption so that saving rate remains robust. This, no doubt, attests to the centrality of improving the saving rate within any effort to enhance the rate of growth. It goes without saying that innovative ways and means to augment saving-rate are crucial for every Muslim country. One of such means, which had an outstanding success in the developed world, is Investment Funds (which are sometimes called Investment Companies). This paper attempts to survey the basic elements of Investment Funds and to discuss some *Shariah* aspects of the working of these funds, and their possible role in economic development.

Significance of Investment Funds:

Investment funds are not new. They go back to the 1920's. However they have become extremely popular world wide over the past decade or so. Total size of investment funds in the U.S.A. increased from $ 500 billion in 1985 to more than $ 1.6 trillion at the end of 1992[1]. Their number, in the U.S.A exceeded 4000 in that same year[2]. In 1994 there were over 5000 registered funds in the U.S.A., with 40 million participants or ¼ of the U.S households[3]. Fidelity alone manages 223 funds worth $ 34 billions[4]. The same remarkable rate of growth in investment funds in the U.S.A. can be observed in many parts of the world. Most importantly, investment funds play an essential role in moving funds across borders for direct investment. Many of what is now called "emerging markets" will never be so without the power of investment funds.

[1] (John Bogle, Bogle on Mutual funds Irwin, 1993)

[2](Albert J. Fredman and Russ Wiles, How Mutual funds work, New York institute of finance 1993 page 8).

[3](Bruce Jacops P.B)

[4](Fidelity world, The secret life and public power of the mutual fund giants Dean B. Henriques, Scribner, 1995)

Growth of Investment Funds in the U.S.A

Year	Total value of Assets
1980	$ 180 billion
1983	$ 250 billion
1986	$ 750 billion
1989	$ 1 trillion
1992	$ 1.6 trillion
1994	$ 2.5 trillion

What is an investment fund?

An investment fund is a diversified portfolio of stocks, bonds, other securities or investments, run by professional managers. They are registered with a regulatory body of the government. The assets of every investment fund are divided into equal-size units. When the fund starts, these units have equal nominal value the total of which represent the Net Asset Value (NAV) of the fund. Changes in NAV are expressed in the form of changes in price of each of these units at each pricing day, though some fund may express such increase in the form of percentage rate of profit.

Funds can be open-end. In this case they stand ready to issue new shares (i.e. units) to incoming investors at current price of the units (net asset value or NAV). They also stand ready to repurchase, or redeem units from existing investors at NAV per units. Every open-end fund will have a pricing day at which the NAV is calculated and investors are allowed to enter or exit the fund. This can be done every week, month or quarter. In some cases this can be a daily process.

A closed-end fund, which are sometimes called investment companies, are again, a diversified professionally managed portfolios. However, they are quite similar to regular stocks. In most cases they even trade in regular exchanges. A closed-end fund don't stand ready either to issue new units or redeem old ones. Hence, their asset remain generally stable for the life of the fund. An investor wishing to liquidate his investment can only get his value in the open market which may or may not equal to NAV.

Advantages of Investment Funds:

What made such funds attractive to investors is the fact that they have several advantages over direct investment and ownership of real assets. Most importantly:

1- Diversification:

A well diversified portfolio contains significantly smaller company-specific risk. Even if some of fund investments get wiped out, the fund will still hold well and may be officiated by gains of other one’s.

2- Professional Management:

Investment funds are managed by skilled and experienced professionals who are periodically judged by the returns they generate. These managers are keen to build a track record. When there is sufficient degree of competition, savers will benefit tremendously from managers desire to tap the economics of scale of fund management.

3- Liquidity:

The speed, ease and cost with which an asset can be purchased and sold is very important to any investor. To the majority of small investors, liquidity is the most important aspect of any investment. Open-end funds are excellent providers for such investment opportunities. Not every direct investment can easily be liquidated at reasonable cost, which makes them unattractive to many investors. Even direct investment in shares and other negotiable assets, can be very expensive to liquidate if done individually. This is one major advantage of Investment Funds.

4- Leverage:

One of the important advantages of investment funds is that of gearing. Being a public company, an investment fund can borrow money and hence enlarge its base of investment. This means more value and income for holders of its units, particularly if the fund management have a good track record which avails to it borrowing at reasonable cost. While this aspect is important in conventional investment funds, it may not be acceptable, as is, from *Shariah* point of view since these loans are interest based. Even conventionally, such gearing may introduce instability in the performance of the fund since the decrease in the market price of its real assets multiplies the loss of income for unit holders.

Theoretical basis for the emergence of Investment Funds:

Human societies consists of two groups of individuals, those who have more resources than they immediately need and those who need more now than they own. With the advent of money it was possible, for the welfare of every one to move these resources from the "excess" group to the "shortage group on a dynamic and continues basis for purpose of investment and consumption. The process of movement of funds was simple and direct. Producers who need funding deal directly with savers who need to do their own assessment of the prospects and the risks involved in providing finance to these users of funds. As life got more complicated through economic development and population growth, the process needed a specialized body to examine and control the risks involved as the process involves a substantial amount of information in analysis, follow-up and collection. Information gathering is very costly. If every provider of funds does his own processing, financing will be so expensive to the point where it no longer feasible for producers to seek outside funding.

It is because of this commercial banks emerged to top the economics of scale and to utilize the advantages of specialization in risk analysis, review and monitoring. Because the law of large numbers then takes effect in the working of a commercial bank making it able to lower the concentration of risk, it was able to separate users of funds from providers of funds to maximize profit for the bank itself.

Commercial banks became financial Intermediaries separating providers of funds from users of funds. Savers, as they lend their money to the bank, actually take the risk of the "bank". They need not bother with assessing the risk of the borrowers from the bank because these are how the risks being borne by the bank. All they need to do is deal with the information about the bank itself (i.e. track record, management, capital....etc.). Banking laws made sure that banks are well supervised minimize the amount of information that need to be procured by a single saver. Investment funds present one important station in the development of financial intermediation. It is now possible, through the model of investment fund to go back to the direct relationship between providers of funds and users of funds. When ever banks are involved their role is to “introduce” parties to each other and avail to savers the advantages of the law of large numbers. This is because their function in investment funds is only managing assets not risks.

Relevance of Investment funds to the principles of Finance In Islam:

While investment funds represent a new direction in the idea of financial intermediation in the West, they are so common to the principles of Islamic finance. Separation of savers from producers is never an Islamic idea. On the contrary, the concept of profit and loss sharing on which most of the Islamic modes of finance is dissimilar to the concept of conventional banking. The model of Islamic banking, which is based on the contract of Mudarabah, don’t allow the bank to separate savers from producers. It puts the bank in the position of manager, where savers directly take the risk of the producers not the risk of the bank.

Investment funds, therefore, are closer to our own system than many financial innovation of recent years.

Why is the model of investment fund so important to Islamic Economics?

Just like commercial banking, investment funds were born in a non-Islamic milien. They represent a major shift in the very basic idea which gave rise to banking, i.e. financial intermediation. Their growth and the important role they play in contemporary finance means that they present an important concept that may afford Muslims a useful tool for financing economic development. This can be two-fold:

a) Investment funds can be very effective in improving domestic saving rate. It goes without saying that no rate of economic growth can be sustained without sufficient domestic savings. The concept of investment funds can be very useful in the regard for these advantages they have over other institutions. For example:

i- Equity based funds allows savers to share in the actual profit generated by producers without taking the high risk of direst investment.

ii- Because of the direct link between savers and producers, the return on investment for the first group is improved because no intermediary is playing (and sharing) any role. In most cases, managers compensation is linked to the actual performance of the fund.

iii- By the means of allowing savers to actually get involved in choosing the right investment opportunity their performance is served better hence creating an incentive for more savings.

b) Investment funds can be an effective vehicle for transferring capital between Muslim countries. The easiness of formation of investment funds, the ease of this management and their appeal to several savers make them excellent for responding to the desire of individual Muslims to investment in Muslim countries. Many internal financial institutions recognized this point. A number if investment funds, managed by such major institutions as Banku Indosueze, formed especially for this purpose. One of the risks that are considered in cross-border investment in what is called country, or sovereign, risks. Like any other type of risks, perspective differ from one person to another. Experience shows that view on Islamic countries sovereign risk differs depending on the origin of investors. Islamic banks have always shown more “appetite” for Islamic risks in response to the preference of their own depositions. This means that investment fun, with their advantage on banks, can be quite vital in inter-Islamic countries capital movements.

Some *Shariah* aspects of Investment funds:

Investment funds are created when investors pool their money for a shared investment goal. Collective power affords an opportunity to participate in a well diversified professionally managed investment portfolio. It is important, from *Shariah* point of view, to examine certain aspects of investment funds. In particular we will evaluate the contractual relationships between the parties involved in the working of a fund, and some operational elements of such funds.

a) Contractual relationships:

The most visible is the relationship between investors and the managers of the fund. Fund management may be based on *Mudarabah*, where the manager, either individual or institution, is the Mudarib and the investors are rub-ul-mall (provider of fund). In such a case, manager will only share in profit in accordance to the ratio spelled-out in the prospectus. his share of profit will be based on the difference between the initial NAV and the NAV at the pricing date since such date represent an accounting liquidation of the Mudarabah.

Many manager would not like their compensation to be tied to profit, but rather prefer to get a fixed remuneration. In such case, the relationship can be based on the Ijarah contract. The manager is, then entitled to an income linked to his managerial effort. Most investment funds management is based on such arrangement. In this case, the manager charges a percentage of the NAV at the pricing date. Ijarah is a permissible contract. However, compensation in the Ijarah contract, like any exchange contract in *Shariah* must be known at the beginning of the period (time of contracting) not the end (time of liquidation), otherwise *gharar* will be present which may void the contract. Although such compensation will not be known exactly at the time of contracting (since it is based on end-of-the-term NAV), it is known in approximate amount, which reduces such *ghara*, though by no means eliminate it. Although the writer is of the view that such Ijarah is permissible, there are some contemporary scholars who think otherwise.

b) Distribution of profit and Redemption of units on accrual basis:

Liquidity is one of the most attractive features of any investment fund. In the case of open-end funds (most investment funds are open-ended) the manager will set a pricing day which will be spelled out clearly in the perspective. In that date the per unit NAV is announced and investors can redeem the cash equivalent of their units from the manager of the fund. When the manager announces profit, based on the NAV figures, this is, in fact, an accounting profit because actual profit will not be realized until assets are actually liquidated. The manager will invest funds in transactions of different maturities to maximize profit. These maturities, in most cases, will not consider with the periodicity of the pricing dates. While this may raise little or no practical problem, it is of much concern to *Shariah* scholars. This is because an investor is only entitled to his rightful share of profit and is obligated to borne his share of loss. An investment fund is, from *Shariah* point of view, a Musharakah of sort. When an investor withdraws his funds at the pricing date with a share of a profit that is only assumed but not actually realized, he may be unfair to the rest of “his partners” (the opposite is also possible).

While scholars realize this problem of fairness, they also recognize the fact the investment in our modern time can’t be done the same way Mudarabah was done in old days when profit is recognized only when total liquidation of all assets are done. Most investments particularly financial one are more or less a going concern, where they go on indefinitely. Unless some arrangement is done for purposes of liquidation, such investment will not be attractive to savers.

One of the major *Ijtihad* of contemporary *Shariah* scholars is what may be called constructive liquidation. Because actual liquidation of all assets by sale is not possible, these scholars allowed liquidation via accounting procedures to be the bases of profit distribution and redemption, given that information about these procedures are clearly spelled out in the prospectus.

c) Reserves:

Reserves are important to the proper management of the fund and the something of payment to the investors. If distribution of profit and redemption of units is done on accrual basis, then reserves are a must for the operation of the fund. Reserves are deducted from the profit generated through the invested funds. This raises two *Shariah* questions. Firstly, whether investors are aware of such deduction and they are consenting to their amount. This problem can be solved through clear mention in the prospectus and signed on the agreement with each investor. Secondly, who own such reserve at the winding down of the investment fund? Many investment funds that are managed by Islamic banks opt for donating such amount at the closing of the fund to charity. One should remember, however, that most of these open-end funds have no specific date nor any future plan for ending the operation of the fund.

d) Guarantee of capital of the fund by the manager:

To attract investors, many conventional fund managers guarantee to the investors the nominal value of their investment. This is not acceptable from *Shariah* point of view. Many advanced to a manager that guarantees it return at the end of the period (or at any time in the future) makes it, from contractual point of view, a lender-borrower relationship. Profit on such money will then be a form of usury (*riba*), even of such profit is variable. In an Islamically managed fund no such guarantee should be made.

e) Restrictions on the type of asset in the Fund:

There are many types of funds. Those which invests in stocks and shares which are called equity funds. And those which invests primary in bonds and money market instruments. There are balanced ones, which mix fixed and variable income securities. There are also ones that diversify into other assets categories such as gold stocks, real estate and special classes of assets. Some investment funds specialize in commodity markets, others do direct finance of trade deals. To be acceptable from *Shariah* point of view it is not enough that the assets themselves are permissible. Certainly a bond-based fund will not be acceptable from *Shariah* point of view. However, there are some classes of assets the case of which is not so obvious. For example is gold stocks and shares in companies that while their main activities are permissible they occasionally deal in non-permissible transactions. In fact the majority of joint-stock companies fall into this category. Obviously we are talking about certain companies which engage in the production of Islamically unlawful things. Rather, we are referring to those which deal, as borrower or depositor, with non-Islamic banks, or with the public through issuance of interest-based bonds. Scholars are in disagreement about investing in the shares of such companies, although the majority thinks that it is not permissible.

Furthermore, operations of the fund must take into consideration the nature and make-up of the assets in that fund. While it is permissible to use the money in the fund to extend credit on Murabaha basis this will mean that the assets in the fund will be debt (account receivable). Such assets are not to be sold from *Shariah* point of view except at face (nominal) value. Because subscription and redemption of investors in the fund are basically sale or purchase of units in that fund, this actually poses a serious *Shariah* complication. Going into details of this aspect is beyond the scope of this paper.

f) Gearing:

One of the most important advantages of investment funds in conventional setting is gearing, i.e. the possibility of pledging the assets in the fund for borrowing and reinvesting to enhance the earning in the fund. This is clearly not acceptable from *Shariah* point of view since these borrowings are interest based.

The rationale behind this approach, is to have some resources in the fund that receive fixed return. Because the fund can generate higher earnings than that fixed return, then participants will have their return on investment improved. It is not wholly unlikely that an Islamically acceptable design to the same effect. For example, the fund can purchase some assets on Murabahah basis using the rest of assets in the fund as collateral.

Using investment funds for infra-structure investment:

Financing public works and infra-structure investment is one of the most difficult aspects of development finance. This is because these projects, usually, generate no net income and hence fail to attract private, profit-based funds. Nevertheless, many infra-structural projects can pay for themselves through users fees, if construction cost can be made available by the private sector. In many countries this is done via loans extended by the banking sector to local or central governments. The funds are then used to build these projects and paid back from government reserves which is mainly coming from taxes and levies. However, there are many drawbacks and weakness for such method:

a) That it is based on interest which makes outside the acceptable means in a Muslim society.

b) That it is not efficient , because the borrowed money will go to government treasury, and payment of loan will again be paid back from the treasury. In other words, these funds will only enhance the Fiscal position of the government to make it capable of such undertaking. Although the fund sources is the profit-based private sector, the implementation of the projects will most likely suffer from the inefficiency of the public sector since they are not performance based. Worse yet, fungibility money may tempt the government to divert some of these funds into other ones hence reducing the effectiveness of this finance scheme.

Income distribution effect:

Financing public projects through government borrowing means that users of the project are not necessarily burdened by the debt of the treasury. Many times this may enhance the equitable description of income.

References

Albert J. Fredman
Russ Wiles
How mutual funds work
Englewood Cliffs, NJ., New York Institute of finance 1993.

Frank Capplello
closed-end funds
Chicago, International Publishing Corp. 1992.

B. Julian Beecham
Investment, a professional approach
London, Pitman, 1988.

Frank J. Fabozzi
Frank Modigliani
Capital markets, institutions and instruments.
Englewood cliff, NJ., Prentice Hall 1992

Bruce Jacobs
All about mutual funds
Chicago, Probus Publishing, 1994.