

A MARKET RENAISSANCE

Islamic finance brings new opportunities to investors with Shariah-compliant investment products in Malaysia.

Diversifying Your Portfolio

Islamic assets are an attraction for global investors looking to expand their portfolios.

You can always count on Dr. Mahathir Mohamad, the former prime minister of Malaysia, to call it as he sees it. "There are as many greedy people among Muslims as there are among the followers of other religions," he said at the Global Islamic Finance Forum (GIFF) in Kuala Lumpur in October 2010. Given the chance, he implied, some Islamic financial institutions could have collapsed under the weight of the recent global financial crisis.

Yet the Islamic financial system has proven remarkably resilient. There were some tremors, among them defaults by Saudi Arabian and Kuwaiti companies on two sukuk (Islamic bonds), worries over Dubai World's debts, whose restructuring was recently completed. But no major Islamic bank or asset management company was forced to close, and now that the worst is over, the Islamic sector is growing as strongly as ever.

The credit should go to Islamic finance's brick-and-mortar foundations, which have withstood the natural greed that capital markets seem to breed as a matter of course. "With its emphasis on assets and partnership, Islamic finance is less exposed to risk," explains HRH Raja Dr. Nazrin Shah, the Harvard-educated Crown Prince of the state of Perak and Financial Ambassador for the Malaysia International Islamic Financial Centre (MIFC) initiative. "By avoiding speculation, Islamic finance reduces volatility and provides a sound basis for financial stability."

This is all good news for the world's 1.6 billion Muslims, who are encouraged to invest only in assets that comply with Islamic law known as Shariah. These Shariah-compliant investment vehicles prohibit the payment of interest fees on loans and are not tainted by usury, speculation, gambling, alcohol, pornography, weapons and other non-



permissible business activities and entities under Islam. They engage only in transparent transactions in terms of pricing, duration, delivery and parties involved, and all financial transactions are supported by underlying productive economic assets.

Investors can pick and choose from Islamic financial instruments domiciled in Malaysia, the Middle East and even Hong Kong, London, Luxembourg and Singapore. They include: listed companies that have been screened as Shariah-compliant by Dow Jones, FTSE, Bursa Malaysia, the national exchange and other bodies; Islamic exchange traded funds (ETFs); real estate investment trusts (REITs), and some 600 unit trust funds that invest in Shariah-compliant equities and in sukuk and other instruments.

According to Kuwait Finance House (KFH) Research, a leading Islamic research organization based in Malaysia, Islamic assets have grown 14% annually from \$150 billion in the mid-1990s to \$1 trillion last year. Deposits with Islamic banks account for 82% of this wealth, but sukuk (12%) and Islamic funds (6%) are increasing their share. Spurring the growth trend has

been the stellar performance of many of these products.

For Non-Muslims Too

All this should be good news as well for non-Muslim investors, who are, contrary to some perceptions, perfectly welcome to invest in Islamic assets. There is no prohibition in Islam about doing business with people who are not of the faith, or in investing in non-Muslim but Shariah-compliant companies such as U.K. resources company Xstrata, Beijing-based PetroChina, Russian utility RusHydro, and Human Genome Sciences in the U.S., all of which were recently added to the Dow Jones Islamic Market World Index.

For the growing band of socially-responsible investment funds—which include university endowments and pension funds around the world—Islamic investment vehicles are an obvious perfect fit. But even conventional portfolios can benefit. The addition of safe, prudent and pure Islamic assets can potentially add ballast to asset holdings that are only now beginning to recover to pre-crisis levels.

A comparison of the Dow Jones Islamic Markets World Index and the Dow Jones World Index shows that Shariah-compliant equities performed better than global equities over the past three years, even at the height of the global financial crisis in 2008.

Shariah-compliant equities outperformed the world index in the past three years



The positive trends are reflected in the performance of Islamic funds. Tracking by KFH Research reveals that the average return on Islamic commodity funds jumped 29% in 2009, compared with a fall of 15.1% in 2008. Equity funds also recovered strongly last year, while money markets funds continued to show moderate but stable returns. The worst performers are fixed-income funds (because of the worries over sukuk defaults, which have now subsided) and real estate funds (given the collapse of the property markets in the U.S. and the U.K.).

Dispelling the Myths

Savvy investors are catching on. At Prudential Fund Management Berhad, the Malaysian unit of British insurance group Prudential Plc, non-Muslims make up 15% to 25% of the investor base of Shariah-compliant products, according to Suraj Mishra, the CEO of Prudential Fund Management. Other asset managers report a higher ratio. "For all the Shariah-compliant products we sell in countries such as Malaysia, some 70% of our clients are non-Muslims," says Manfred Dirrheimer,

HOW TO LAUNCH AN ISLAMIC FUND

As Islamic finance takes off around the world, fund management companies will have to develop a strategy to get a foothold in this fledgling marketplace. Here's a step-by-step approach based on the experience of Prudential Fund Management, which set up Prudential Al-Wara' Asset Management last year under the MIFC initiative. There are 14 other Islamic Fund Management companies in Malaysia such as Franklin Templeton GSC, Nomura Asset Management, BNP Paribas Investment Partners, Reliance Asset Management and Asian Islamic Investment Management (joint-venture between Singapore's DBS Asset Management and Hwang DBS Malaysia).

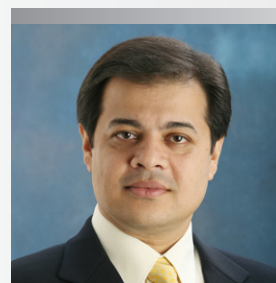
- **First, form an Islamic unit.** "Our hub for Islamic funds is Malaysia," explains Suraj Mishra, Prudential's CEO, "while the global hub for conventional funds is Luxembourg." There are legal, financial and structural issues unique to an Islamic organization. For example, Islamic funds must be segregated from conventional funds, which may have been generated from prohibited activities under Islam, such as usury.

- **Get advice from a Shariah board.** For its new Prudential Shariah Opportunities - Asia Pacific Equity Fund, Prudential appointed a Shariah Adviser that is recognized in Malaysia and the DIFC. The Shariah Adviser's Supervisory Board is composed of well-known scholars from Saudi Arabia, Malaysia, Kuwait and Qatar. It will certify that the assets of the Prudential Shariah Opportunities - Asia Pacific Equity Fund comply with Islamic law, and will conduct periodic audits to make sure they remain so.

- **Choose an appropriate Islamic finance center as a domicile.** Prudential's new Shariah fund is based in Malaysia, but there are other choices such as Bahrain, Cayman Islands, Dubai, Indonesia, Ireland, Luxembourg and Saudi Arabia.

Malaysia provides tax breaks to eligible fund management companies, allows 100% foreign ownership, and has mutual recognition arrangements with other jurisdictions.

- **Walk, don't run.** Prudential's new fund is structured flexibly, allowing it to offer fund classes denominated in Ringgit, U.S. dollars or any other currencies, and distribute the fund across the world, subject to the approval by respective regulators in the countries of distribution. But Mishra says Prudential will be pragmatic. The U.S. dollar denominated class will be launched first in DIFC (Dubai), which has a Mutual Recognition Agreement signed by the Dubai Financial Services Authority and the Securities Commission of Malaysia to distribute each other's Islamic funds. "Take baby steps," he says. "After Dubai, you can go to Qatar, Kuwait, UAE, Abu Dhabi, and then after it's been able to be accepted more, you can try more developed markets with a highly regulated distribution environment [such as Europe and Australia]."



"Our hub for Islamic funds is Malaysia; while the global hub for conventional funds is Luxembourg."

— Suraj Mishra, CEO, Prudential Fund Management Berhad



“A global consensus on Shariah interpretations is emerging with the establishment of ISRA, which provides a platform for greater engagement among scholars from different places to discuss and exchange ideas.”

— **Mohamad Safri Shahul Hamid, Deputy CEO, MIDF Amanah Investment Bank**

chairman of the board of German financial services company FWU AG.

But there is still wariness. There is a perception that an asset judged to be Shariah-compliant in one jurisdiction may not be considered Shariah-compliant in another, creating uncertainty that worries institutional investors, in particular. Daud Vicary, Global Leader of the Islamic Finance Group at Deloitte, a Big Four accounting and consulting firm, says this is not the case. “If you look at the fatwa or Shariah pronouncements which have been made over the last decade in Islamic finance, more than 95% of them have been in complete accord across all schools [of Islamic thought], with only about 5% where there are differences of opinions,” he says.

Mohamad Safri Shahul Hamid, a former Deutsche Bank executive who is now Deputy CEO of MIDF Amanah Investment Bank, points out that a global consensus on Shariah interpretations is emerging as scholars from different places regularly meet to discuss and exchange ideas. An example of such platforms is the International Shari’ah Research Academy for Islamic Finance (ISRA) Council of Scholars Meeting at GIFF 2010 in Kuala Lumpur. “If you can get acceptance by majority of the Shari’ah scholars, then product can be marketed globally,” he says.

Safri quotes the benchmarks used by Dow Jones to compile its various Islamic markets indexes as an example of globally accepted standards. These indexes are based on the advice of an independent Shariah Supervisory Board

and follows the broad principles laid down by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). Like other institutions such as Yasaar Ltd., FTSE Group and Securities Commission of Malaysia’s Shariah Advisory Council (SAC), Dow Jones screens out companies engaged in alcohol, tobacco, pork-related products, conventional financial services, defense/weapons and entertainment.

Do these requirements unduly limit the investment universe for Islamic products and therefore hold back portfolio performance? “Gambling, alcohol and tobacco constitute only a small portion of global GDP,” says Steven Choy, President/CEO of Cagamas Berhad, the National Mortgage Corporation and leading securitization house in Malaysia. Drawing on experience of Cagamas in sukuk issuance, Choy also challenges the notion that Islamic products are more expensive than conventional instruments because of the Shariah-compliance process. “Like all new structures, Islamic or conventional, there are initial structuring expenses. However, in the long run, these additional costs are not significant and Cagamas’ sukuk issuances are able to be competitively priced,” he says.

Opportunities for Tomorrow

Going forward much depends on the continued development of Islamic finance. “As we usher into a new decade, it is timely for the industry to reflect on its existing strengths and build new capabilities to create new engines of growth,” says Dr.

Zeti Akhtar Aziz, Governor of Bank Negara Malaysia, the central bank. “Islamic finance must continue to evolve to address the emerging issues and new challenges and leverage on the emerging opportunities in this increasingly more globalised environment.”

Dr. Zeti particularly flags the further internationalization of Islamic finance. One important milestone was recently achieved with the establishment of the International Islamic Liquidity Management Corporation (IILM) by 11 central banks consisting of Indonesia, Iran, Luxembourg, Malaysia, Mauritius, Nigeria, Qatar, Saudi Arabia, Sudan, Turkey and the United Arab Emirates. The Islamic Development Bank (IDB) and the Islamic Corporation for the Development of the Private Sector are the two multilateral organizations also participating in the IILM initiative.

The IILM will tap on the formidable cash reserves of its owners to issue high-quality Shariah-compliant financial instruments that will facilitate efficient cross-border investment flows and help Islamic financial institutions manage their liquidity needs more effectively. It is just one example of how rapidly Islamic finance is maturing – and how international investors are being offered more choices in diversifying their portfolios and maximizing returns without taking on too much risk.



“Malaysia is awash with investable funds and there is a huge savings rate.”

— **Steven Choy, President/CEO, Cagamas Berhad, the National Mortgage Corporation of Malaysia**

Investing In Malaysia

Investors can tap the wide range of investment opportunities and incentives in Asia's leading Islamic financial center.

Earlier this year, executives of Prudential Fund Management Berhad, a unit of the U.K. insurance giant Prudential Plc, spoke to Securities Commission Malaysia (SC) about launching a foreign-currency denominated Islamic fund in Malaysia and overseas.

"SC very quickly wrote the regulations to allow this," says Suraj Mishra, the CEO of Prudential Fund Management. "Everything was done very efficiently." The SC issued the new regulations in June and Prudential is now awaiting approval to launch the U.S.-dollar denominated Prudential Shariah Opportunities - Asia Pacific Equity Fund. "There is no doubt that the SC is very helpful," says Suraj. "Fulfilling their obligations as the industry regulator, they have been very thorough in their approval process, as this is the first offshore fund which Malaysia will showcase to the world."

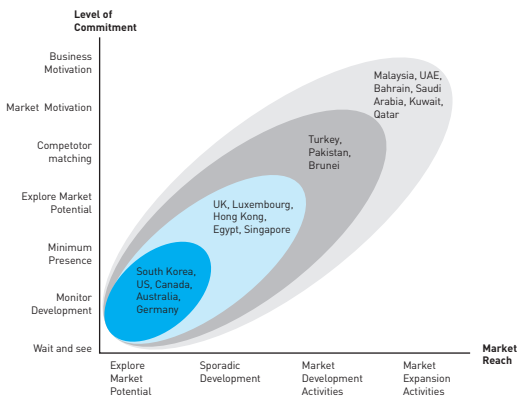
Such supportive but prudent regulators is a key reason why Malaysia has been topping the league tables of the world's Islamic financial centers. In a survey of 19 such jurisdictions by KFH

Research, the Southeast Asian nation was ranked number one overall. In terms of market reach and level of commitment, Malaysia is adjudged in a class of its own along with the United Arab Emirates, Bahrain, Saudi Arabia, Kuwait and Qatar.

Malaysia's commitment to Islamic finance is embodied in the Malaysia International Islamic Financial Centre (MIFC) initiative, which strengthens Malaysia's position as the international Islamic financial hub. The MIFC initiative knits together the nation's financial and market regulators, including Bank Negara Malaysia (the central bank), Securities Commission Malaysia, Labuan Financial Services Authority, Bursa Malaysia (the national exchange), as well as domestic and international financial institutions offering Shariah-compliant products and services, government ministries and agencies, human capital development institutions and professional services companies, working collaboratively in Islamic finance.

The MIFC initiative deals with every aspect of Islamic finance, including the Islamic capital market, Islamic fund management, international Islamic banking, international Islamic insurance known as takaful, and human capital development. The result is a vibrant Islamic finance community that is open to everyone, Muslims and non-Muslims alike, offering significant incentives and backed by strong government support.

Malaysia Is The World's Most Committed And Expanding Islamic Financial Center



Favored Hub

For global investors, Malaysia is a strategic center. The country is home to 171 Islamic funds, more than a quarter of the total 600 globally, according to KFH Research. It accounts for half of the world's 20 biggest equity funds. Topping the list: the \$1.7-billion Public Islamic Select Treasures Fund. Malaysia is also the global leader in the \$100-billion Islamic bond or sukuk market, accounting for 54.2% of all global sukuk issued last year.

FIFTEEN MALAYSIAN MARVELS

One thing to remember about Islamic funds is that many are less than three years old. As such, they are not rated by fund trackers like Morningstar, which awards its star ratings for performance over three years, five years and ten years. Of the 171 Malaysia-domiciled Islamic funds tracked by KFH Research, a third do not yet have a three-year track record. Below are the 15 best-performing Malaysian Islamic funds over three years, which retail and other investors, whether Muslim or non-Muslim, can consider diversifying investment sources and portfolios.

	Total return	
	3 years	1 year
Kenanga Syariah Growth Fund	22.6%	25.0%
RHB Islamic Bond Fund	22.4%	7.4%
TA Islamic Fund	21.5%	12.4%
PB Islamic Bond Fund	21.2%	10.6%
Public Islamic Bond Fund	21.0%	8.6%
MAAKL Al-Umran	19.4%	12.8%
Maybanlife Dana Ekuiti Prima	19.1%	30.2%
Interpac Dana Safi	18.7%	32.7%
Public Islamic Opportunities	16.0%	23.2%
Manulife Dana Ekuiti Dinamik	15.6%	20.7%
AIA Dana Dinamik	15.6%	19.4%
AMBon Islam	15.6%	7.7%
Pacific Dana Aman	15.2%	17.8%
GE Dana Sejati	15.1%	8.4%
CIMB Islamic Dali Equity Growth Fund	14.0%	17.0%

Source: KFH Research. As at August 3, 2010.

Daud Vicary, Global Leader of the Islamic Finance Group at Big Four accounting and consulting firm Deloitte, credits Malaysia's success to its robust Islamic finance infrastructure, supportive government, stable and robust legal, tax and regulatory environment, increasing supply of human capital and widening choice of highly innovative Islamic finance products. "Malaysia deserves to be a main catalyst and benchmark for the Islamic finance industry as well as intermediary of investment opportunities," he says.

Also attractive are the incentives and tax breaks that the country extends to fund management companies and sukuk issuers, which are often passed on to investors in the form of lower set-up and management fees. The concessions include tax exemption until 2016 on all fees received by fund management companies for managing approved Islamic funds for both local and foreign investors, tax exemption on interest or profits paid to an individual investor, and tax exemption on profits in respect of foreign currency Islamic securities.



"Malaysia deserves to be a main catalyst and benchmark for the Islamic finance industry as well as intermediary of investment opportunities."

— Daud Vicary, Global Leader of the Islamic Finance Group, Deloitte

And the country is awash with investable funds. With GDP in nominal terms of \$193 billion, Malaysia is the world's 40th largest economy. "There is a huge savings rate," says Steven Choy, President/CEO of Cagamas Berhad, the National Mortgage Corporation of Malaysia. Companies and employees are required to contribute a combined minimum of 23% of worker wages to the Employees Provident Fund, supporting a national savings rate that is estimated at 30% to 40%.

Cagamas has been tapping this well of liquidity for the past two decades, but it has lately been focusing on sukuk

Malaysia Dominates The List Of The World's Largest Islamic Equity Funds

	Domicile	Investment Focus	Size (\$ m)
Public Islamic Select Treasures Fund	Malaysia	Malaysia	1,669.9
Amana Growth Fund	U.S.	U.S.	1,520.0
Amana Income Fund	U.S.	U.S.	1,030.0
Al-Amanah Saudi Equity Fund	Saudi Arabia	Saudi Arabia	809.4
Public Islamic Dividend Fund	Malaysia	Malaysia	619.7
Oasis Crescent Equity Fund	South Africa	South Africa	557.8
Al Raed Saudi Equity Fund	Saudi Arabia	Saudi Arabia	550.9
Riyad Equity Fund 2	Saudi Arabia	Saudi Arabia	511.2
Public Ittikal Fund	Malaysia	Asia Pacific	509.9
Public Islamic Equity Fund	Malaysia	Malaysia	412.3
CIMB Islamic DALI Equity Growth Fund	Malaysia	Malaysia	375.7
Public China Ittikal Fund	Malaysia	China	304.6
Samba Real Estate Fund	Saudi Arabia	Saudi Arabia	291.2
Public Islamic Optimal Growth Fund	Malaysia	Malaysia	248.8
Public Islamic Asia Dividend Fund	Malaysia	Asia Pacific	246.6
MyETF DJ Islamic Market Malaysia Titans 25	Malaysia	Malaysia	202.8
Alahli Global Trading Equity Fund	Saudi Arabia	Global	176.6
Al Bilad Asayel Fund	Saudi Arabia	Saudi Arabia	175.3
Public Islamic Sector Select Fund	Malaysia	Malaysia	165.8
Public Asia Ittikal Fund	Malaysia	Asia Pacific	157.3

Source: KFH Research. As at August 3, 2010.

and other Islamic debt instruments because both Muslims and non-Muslims can invest in them, which is not the case with conventional instruments. Like other corporate sukuk, Cagamas Islamic paper is meant for institutional investors but retail investors can gain indirect

foreigners account for 20% of market cap.

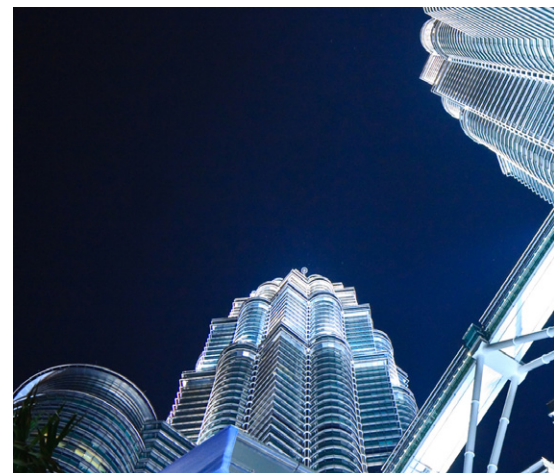
The bellwether FTSE Bursa Malaysia Kuala Lumpur Composite Index hit a historic high of 1,528 points on November 10 this year. The FTSE Bursa Malaysia Emas Shariah Index, comprising 349 Shariah-compliant companies, closed at 10,351 points on the same day, up 74% from 5,949 points on December 31, 2008. In all, the Malaysian exchange has 864 Shariah-compliant companies, giving global investors a variety of investment options.

Investors can also opt to buy a Shariah-compliant index with the Dow Jones Islamic Market Malaysia Titans 25, Asia's first Islamic ETF. It tracks Malaysia's 25 largest blue chip Shariah-compliant companies, including

exposure by investing in sukuk or bond funds at this juncture.

Historic High

Cagamas and a number of other sukuk are listed on Bursa Malaysia, but only for information and profiling purposes. The stock market has yet to receive regulatory approval to trade them. On the other hand, Shariah-compliant stocks and Islamic ETFs and REITs are quoted and traded on the exchange, and accessible to both local and foreign investors, Muslim and non-Muslim. At \$368 billion, the Bursa's market capitalization is the second largest in Southeast Asia after Singapore's;



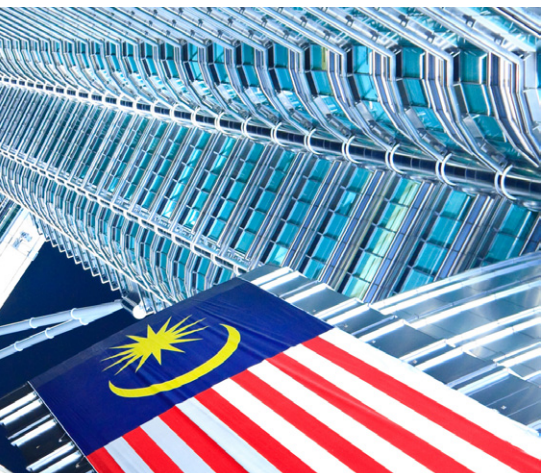
conglomerate Sime Darby, mobile phone company Maxis and Genting Plantations. There also three Islamic REITs – Al-Aqar KPJ, which owns hospitals and health-care facilities, Al Hadharah Boustead, which has oil palm plantations and mills, and AXIS, owner of office and commercial buildings.

New Investment Vehicles

What next? Already the world's top sukuk listing destination, Bursa Malaysia has launched Bursa Suq Al-Sila', the world's first end-to-end Shariah-compliant and fully electronic commodity trading platform that facilitates commodity-based Islamic financing and investment transactions under the Shariah principles of Murabahah, Tawarruq and Musawwamah. This trading infrastructure, which enables financial institutions to create Shariah-compliant financial products using crude palm oil as the first underlying commodity, is poised to spur the development of Islamic investment in Malaysia. "We need to develop more Islamic products," says Bursa Malaysia CEO Yusli Mohamed Yusoff. He continues "We have a team here in Bursa Malaysia that is dedicated to developing the Islamic market."

With the MIFC community developing more innovative Shariah-compliant products, such as the multi-currency and multi-class Islamic fund, global investors will have every reason to invest in Malaysia.

To find out more on Shariah-compliant investment value propositions, visit www.mifc.com/viewpoints



ISLAMIC SOLUTIONS

Institutional investors face the challenge of disrupted issuance of long-dated financial instruments after the global recession. "The composition of papers, both Islamic and conventional, with a tenure of 15 years and above [currently] make up 15.7% of total outstanding issuances, a reduction from 17.9% a year ago," says Mohamed Hassan Kamil, Group Managing Director of Syarikat Takaful Malaysia Berhad, the first full-fledged takaful operator in Malaysia. Takaful is a protection plan based on Shariah principles, involving participants that mutually agree to guarantee each other against defined losses and sharing profits with the takaful company. Excerpts from an email interview:

Takaful Malaysia can invest only in Shariah-compliant assets. How did its portfolio perform during the crisis?

Overall, investments in Islamic finance assets fared better than conventional investments. This is mainly due to the structure of Shariah-compliant investment products, which emphasize asset-backing principles, center on risk-sharing, and are shielded from over-leveraging. The downside risk is limited because Islamic products are more transparent and focus on ethics and fairness.

At Takaful Malaysia, we have been able not only to ensure high level of solvency but also exceeded our participants' reasonable expectations in terms of profit-sharing. Takaful Malaysia has been able to offer profit-sharing of 15% of the contribution amount to its General Takaful and selected Family Takaful participants. The profit-sharing principle of mudharabah will only be applied if there are no claims incurred during the coverage period.

How is your company coping with the shortage of long-dated paper?

It will not have a significant impact on our pursuit to achieve our corporate objectives and gain competitive advantage. Through our dynamic asset allocations and active management investment approach, we will continue to ensure high solvency of takaful funds while exceeding the



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— Mohamed Hassan Kamil,
Group Managing Director,
Syarikat Takaful Malaysia Berhad

participants' reasonable expectation in terms of investment return.

We are positive about the latest developments in the Malaysian Islamic debt capital market. We have seen last year the first ever 30-year sovereign-risk Sukuk. We will probably see more long-dated Sukuk issued either by the government or corporates to meet the requirements of long-term funding for the high-impact infrastructure projects under Malaysia's Economic Transformation Plan (ETP).

Will the International Islamic Liquidity Management Corporation (IILM) help?

IILM would partly help ease the problem. Ideally, the liquidity management tools to be made available via IILM should spur the development of Islamic products with wider acceptances, including long-term and innovative products appropriate for takaful investment.

What new Islamic investment products would you like to see in the next five to 10 years?

We would like to see more unique products being developed based on the requirement of Islamic institutions, not just Shariah-compliant products that mirror existing conventional instruments. Apart from that, we would like to see more initiatives from the government such as better tax incentives on Islamic products and multilateral, cross border issuances in an integrated manner.



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Which country is enabling the evolution of Islamic finance?

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