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Hedge funds: Industry once more at centre of attention

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For the past two years, the development of a *shariah*-compliant hedge fund industry – once one of the hottest topics at alternative investment conferences – has been on hold.

But as the asset management industry – and wealthy institutions and individuals in the Middle East – pick themselves up from the damage wrought by the financial crisis, the issue of whether an Islamic hedge fund industry is viable, or indeed even desirable, is being taken up again.

The notion is attractive not least because the past few months have seen a series of developments in *shariah* finance that go some way to overcoming many of the obstacles that had faced hedge funds looking to comply with Islamic strictures.

Secular trends in the asset management industry seem to be on the side of some form of Islamic hedge fund market too.

The field of *shariah* finance remains one of the fastest growing areas in the global finance industry, with estimates from analysts varying between 20 and 40 per cent growth annually for the next five years at least.

Furthermore, interest in hedge funds and alternative products in the Middle East in particular is on an upward trend.

According to a recent survey of institutional investors in the region by the consultancy Capintro, 36 per cent of respondents said they were planning to increase their hedge fund allocations, while a further 53 per cent said they intended to hold allocations steady.

If anything, the recent Dubai debt crisis, has made interest in hedge funds more pronounced. Many institutional investors in the region have seen property-linked holdings fall sharply in value and are looking to reallocate port-folios.

A comprehensive report on the hedge fund industry conducted by the consultancy Casey Quirk and Bank of New York Mellon in April last year projected that money invested in hedge funds by Middle Eastern investors would rise to $194bn by 2013.

Fundamental problems remain, however.

By definition, a hedge fund is an unregulated investment vehicle open only to qualified investors that has free reign to pick and choose across the gamut of financial instruments and securities indiscriminately to reduce risk while delivering high returns.

Islamic finance, however, can be strictly prohibitive on certain types of financial practice.

Most notably, as far as hedge funds are concerned, shorting – a bet that aims to make money from the decline in value of a security – is banned.

Shorting is fundamental to almost every hedge fund strategy and is the main means by which hedge funds look to fulfil their generic mandate – as an investment class – delivering returns uncorrelated to regular markets.

Collecting interest, known as *riba*, is also proscribed, again reducing the investment universe open to hedge funds. And more generally, investments determined to be *maysir* or *gharar* – that is, speculative or involving unavoidable uncertainty – are to be shunned too.

As a result, successful *shariah*-compliant hedge funds have been almost exclusively focused on commodity markets. Funds that trade in commodities – tangible assets – face fewer restrictions under *shariah* law than those trading in more abstract financial instruments.

Such *shariah*-compliant commodity funds have, however, been successful. Dubai Shariah Asset Management Kauthar runs four commodity funds, all of them *shariah*-compliant.

The company's flagship multi-strategy fund, which blends investments in its four underlying funds, has been one of the most successful fund-of-fund structures so far this year.

In 2009, the DSAM Kauthar commodity fund was up 41 per cent, not only marking it out as one of the best *shariah*-compliant investments that year but also one of the best hedge fund performers globally. The average hedge fund returned just over 20 per cent in 2009, according to industry indices.

Replicating such *shariah*-compliant successes in hedge funds that trade in assets other than commodities may not be as far off as many believe, however.

On March 1, the International Swaps and Derivatives Association, the global trade body responsible for standard-setting in the derivatives market, issued the ISDA Ta'Hawwut agreement that will allow market participants to enter into derivative contracts that are *shariah*-compliant – and do so on a level playing field.

Such uniform standards, potentially open to a host of different types of financial trade, may finally unlock hundreds of previously prohibited markets to funds planning to make *shariah*-compliant investments.

The key in every instance will be for fund managers to persuade Islamic scholars that their investments are hedges rather than outright speculative positions.

One big question for investors must remain, however: even if it is possible to construct an Islamic hedge fund, will it be possible to run one that performs?