Moving markets

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Political concerns and poor conditions on global capital markets are encouraging Arab investors – both institutional and private – to ask difficult questions of the asset management industry that serves them. ***Tom Everett-Heath*** *reports*

Contrary to the expectations of some, the 21st century did not dawn with Y2K-induced disaster. Computers didn't crash, banks didn't fail and the lights stayed on. However, with hindsight, it is clear that a different disaster was just beginning. The FTSE-100 index hit an all-time high on the last day of trading in 1999. Since then it has been a long downhill run for the London Stock Exchange and most other major global equity markets. The longest bear market in generations has brought international investors to their knees.

Middle East investors have not escaped unscathed. Crashing markets and political concerns have combined to force a rethink of investment strategies. The full impact of this transition has yet to be worked through, but early markers are visible. Attitudes towards asset class allocations, geographical diversification, domestic markets, risk management and custody are in flux. It is too early to call exactly how the new patterns will be formed, but the period of transition undoubtedly offers opportunity for asset managers active in the region.

For a start, the identity of these asset managers is undergoing a transformation. The evidence is anecdotal, but since the 11 September 2001 strikes on New York and Washington and the US' response, there has been a drift of Arab assets away from US financial institutions towards European players. "Some Arab investors have listened to the rhetoric coming out of the US and have become uncomfortable with the perceived political risk of having US houses as their intermediaries," says Philip Winder, managing director of Polygon Investment Management. "There is a trend of assets moving to European houses in the search for 'one degree of separation.'"

Systemic shifts provide opportunities for those asset managers seeking new mandates, and the ongoing political uncertainty has been compounded by concerns over performance. "There has been inertia over changing managers – some investors have been reluctant to realise losses – but we are now at the point of reallocation," says David Waite, head of asset management at Gulf International Bank. "There are a growing number of regional clients who are unhappy over the performances of their investment managers."

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There is evidence – again anecdotal – that some of the larger asset management houses may not have met the expectations of their clients. "The reputations of many of the big players have been hit by faulty management, faulty markets and faulty morals," says Winder. "The constant drip of problems – such as the conflict of interest for investment banks issuing equity research – has eroded confidence. There will be a drift towards asset management by smaller, more focused companies. Arab investors are getting fed up."

Disappointment over performance has also fuelled alterations in portfolio investment strategies. "Most investors now realise the mid-1990s equities markets have gone and it is hard to find a vision of those sorts of returns. The huge run has come to a juddering stop," says Tariq al-Samahiji, vice-president at BNP Paribas Asset Management. "A lot of money has moved to the sidelines over the last couple of years. But the real change is that the concept of proper risk management has come to the fore. When the market environment was very strong, investment banks allowed risk management to go wrong. Their clients paid the price."

Diversification

As a result, recent months have seen a greater concentration on diversification, both across asset classes and in allocations within sub-asset classes. "The support cushions of diversification have been well understood by Arab investors for some time, but they are now learning about how to diversify effectively within asset classes," says Al-Samahiji.

There has also been increased appetite for more structured products. "We've not seen great changes, but there are signs of a greater aversion to risk," says Waite. "There has been more interest in cash deposits and capital-protected structures, but these structures can be expensive."

Certainly, alternative investments have attracted greater attention, with hedge funds, private equity and real estate investments increasingly prominent within the portfolios of Arab investors.

Political undercurrents have also turned the spotlight to the geographical movement of assets. Many headlines have been dedicated to the 'Return of Arab Capital to Arab markets', but evidence of the mass liquidation of Arab investments in US and their reinvestment in the region is scant. For example, last year the aggregate increase in customer deposits throughout the entire banking sector in Saudi Arabia amounted to only SR 20,000 million ($5,333 million), which, with a growth rate of 7.7 per cent, was in line with organic domestic expansion. Equally, the Saudi Arabian stock market – the largest bourse in the Arab world by a considerable margin – only saw its market capitalisation increase by SR 6,200 million ($1,650 million) during 2002. Such figures do not equate with a massive repatriation of funds.

"There has been no huge movement of funds out of the US," says Polygon's Winder.

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A concentrated market

Asset managers the world over have a healthy interest in the size of their market, the share of invested assets they have under their management and how their rivals are performing. In some markets, such information is readily available and pored over. Not in the Middle East. The secretive nature by which some of the largest institutions go about their business, combined with the fact that 'private' is the operative word in private banking, has led to details of the Arab world's invested assets being thin on the ground.

Once a year, the Merrill Lynch/Cap Gemini Ernst & Young World Wealth report takes a stab at estimating the total worth of the region's high net worth individuals (HNWIs). In the last report, published in June 2002, it guessed that the Middle East had 290,000 HNWIs sharing $1,000 billion of invested wealth. Private bankers in the Middle East are prone to shrugging their shoulders when asked about the accuracy of the figure.

MEED estimates, based on a survey of asset management executives active in the region, are a little more conservative (see table). About 250,000-300,000 HNWIs have about $600 billion between them, a sizeable proportion of which – perhaps more than $100 billion – is owned by only 3,000 super HNWIs. To this can be added the assumed assets of a small number – less than 20 – of government and parastatal institutions. The Abu Dhabi Investment Authority, the Kuwait Investment Office, the more recently formed Qatar Investment Office and others, alongside state pension funds and other government-managed institutions, have aggregate assets of about $700 billion.

Staggering as these figures are, they need to be put in context. The 300,000 Middle Eastern HNWIs account for less than 0.01 per cent of the region's population. In the US, almost one person in 100 is a HNWI.

However, even if the regional asset management universe is small in global terms, it is of great economic importance. The $1,300 billion figure for aggregate funds – the vast bulk of which is controlled by the Gulf – is the equivalent to more than four times the gross domestic product of the six GCC states. For those economies dependent on oil revenues, dividend payouts and drawdowns from state-controlled investments act as an important cushion when body-blows are dealt by depressed oil prices.

In addition, at a time when almost all governments in the region are rolling out aggressive economic liberalisation plans in an attempt to attract foreign direct investment (FDI), offshore wealth offers an attractive alternative. Most FDI targets would be comfortably hit if only a small proportion of regional assets invested abroad was channelled into the domestic economies.

The Middle East: a pyramid of wealth

	Numbers	Invested assets ($ billion)
Institutions	15	700
Super HNWI	3,000	100
Very HNWI	45,000	300
HNWI	250,000	200

HNWI: high net worth individuals
Source: MEED

"Most of the reduction in US holdings has come from losses, not politically-inspired money movements. But there has been a slowing in the regional outflow of funds. There is a greater desire to keep money within the region."

"There is a greater desire to keep money within the region"

Philip Winder, Polygon Investment Management

But regional investment opportunities are comparatively limited. "The most important growth in regional investment has been in the domestic real estate market," says a banker active in the regional asset management market. "Local investors have a different view of regional political risk to international investors and one of the main drivers of domestic real estate markets has been the perception of security."

Booming real estate valuations across the Gulf – most visible in the more active markets such as Dubai, Riyadh and Bahrain – support the assertion.

However, there are signs that the current trickle of funds into regional markets could accelerate. Comparatively small, thin and illiquid as they are, Middle East equity markets have a number of attractive qualities. First, they are uncorrelated to the bourses of the rest of the world and, at a time when global markets are moving in the wrong direction, this can demand attention. Second, they are extremely high yielding – for investors seeking cash returns and dividend payouts, the Middle East's average yield of almost 4.5 per cent is intoxicating in a low interest rate environment. Third, and perhaps surprisingly, the markets have low levels of volatility.

"Regional money is just beginning to flow into regional equities and real estate," says BNP Paribas' Al-Samahiji. "The saying holds true: money is a coward and it will always return to where it feels safe."

A coward it might be, but money is also more rational than emotional. If better opportunities can be found elsewhere – with the right blend of risk – it will soon set off again.

Home-grown revolution

The regional asset management industry is on the cusp of a revolution. Economic liberalisation, privatisation and the development of regional capital markets will transform the landscape.

Speaking at the second MEED Asset Management Conference, staged in Bahrain in late January, Shuaa Capital executive managing director Ziad Makkawi predicted that total pooled assets invested in the region will reach $76,000 million by 2010, with total mutual funds amounting to about $39,000 million – 70 per cent of which will be invested in equities. He forecast that the money market will capture about 15 per cent of the $275,000 million in total bank deposits and that a sizeable proportion of these money market instruments will be Islamically-structured.

Makkawi estimates that public pension funds will grow to about $134,000 million in size, of which 50 per cent will be invested locally and 20 per cent – or $27,000 million – will be managed by the private sector. In addition, the insurance sector is expected to outsource a growing proportion of its balance sheet, which is expected to grow to about $6,000 million by 2010. And the killer forecast made was that, over the next seven years, the regional asset management industry will generate cumulative revenues of $1,800 million, with annual revenues of more than $400 million in 2010.

Massive potential

Remarkable as this vision of the future is, it is based on surprisingly sober assumptions. "Currently only 1 per cent of local savings are deployed in regional mutual funds, with equity funds capturing less than 1.3 per cent of the $160 billion GCC market capitalisation," said Makkawi. In addition, only 20 per cent of the $10,500 million worth of mutual funds managed in the GCC is invested locally. If these, and other, statistics follow the development patterns of other markets such as Brazil, Singapore or China, some of Makkawi's forecasts might prove to be conservative.

The key is the effectiveness of government attempts to build conducive regulatory environments. The focus must fall on the creation of asset pools through the development of public pension funds and the regional insurance industry, and the allocation of these pooled assets. Real progress has already been made, with the Bahrain Monetary Agency (central bank) at the cutting edge of regulatory development, particularly in the niche market of Islamic products and services. Significantly, Saudi Arabia, with its capital markets law, Qatar, with its proposed mutual fund bill and Dubai, with its plans for the Dubai International Financial Centre, have all prepared draft legislation that will contribute to the development of regional capital markets and asset management.

"Given the region's demographics, the increasingly sophisticated nature of regional investors and ongoing liberalisation and regulatory reform, the industry is set to grow substantially," added Makkawi. Even if his estimates prove to be exaggerated, the opportunities will still be considerable.

Everett-Heath

BMA: at the cutting edge of regional regulation