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Islamic finance: New tech, new opportunities

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THE world of Islamic finance and investing represents an exciting world of opportunities for Muslims all over the world, and one we think should likely continue to grow. I recently had the pleasure of attending the Global Islamic Finance Forum (GIFF) in Malaysia.

For those who are not familiar with Islamic finance, it encompasses both equity and credit-based investments (called sukuk) that are compliant with Islamic (Shariah) law. The goal is the same as with other types of investments: to produce a favourable return and/or generate income.

The difference is that Islamic investments must adhere to various tenets, including the prohibition of the payment of interest (so-called "riba") as well as certain forbidden activities and products including alcohol, armaments and a number of foodstuffs and food-related activities.

The interpretation of what is Shariah-compliant and what is not can be complex, requiring the active involvement of Islamic scholars (who may not always agree). This can add a layer of complexity for investors. If the main business of a company is not deemed compliant with Shariah law, a portfolio manager cannot purchase, hold or sell its shares.

Of course, the desired goal or purpose of any investment is to make money for those who invest in it. So, I think it is worth a look at how these types of investments have performed versus emerging market equities and versus global equities in developed markets more broadly.

We would note that Islamic investment indexes in Indonesia, Turkey and Malaysia have seen some periods of volatility but have generally outperformed many other countries in this category since 2002.

If you look at the sector weightings of the MSCI Emerging Markets Islamic Index versus the more general MSCI Emerging Markets Index, you will see significant differences. For example, financials is much smaller in the Islamic Index, while consumer discretionary and energy are much higher for the Islamic Index.

Malaysia's equity market has experienced weakness this year, along with its currency, which fell to its lowest level versus the US dollar since the mid-late 1990s, at a time Asia was experiencing a financial crisis. We had to ask ourselves: Was it really that bad in the country — was this year's sell-off justified? There are many ways to determine currency valuations, but we use purchasing power parity to help determine whether a currency is overvalued or undervalued. This measures inflation in one country versus inflation in the US.

So, for example, if inflation in Malaysia, China or any other country is higher than inflation in the US, those currencies should naturally decline versus the dollar. Based on this measure, we currently see the currencies of both China and Malaysia, as well as the currencies of Indonesia, Thailand and Saudi Arabia, appearing to be undervalued. We also see equities in emerging markets generally undervalued based on measures such as price-to-earnings and price-to-book ratios.

Looking at some other fundamentals in Malaysia, we know that the country is a net exporter of oil and gas, so lower prices have had a negative impact. Palm oil is also a key export for Malaysia (the world's second-largest producer) and its price has been weak, and that certainly has had at least a psychological market impact.

However, the use of palm oil globally is not declining, mainly because of demand from China and India, and we don't expect prices to stay permanently depressed. Additionally, Malaysia has a diverse array of export products, and is actually predominantly a consumption-driven country (representing 60% of gross domestic product (GDP)), so commodity prices alone cannot explain the dire situation the markets seemed to be reflecting there. Malaysia's economy has a large service sector, which to me is a sign of its maturity.

GDP growth since 1996 has averaged about 5%, and while various forecasters call for growth below that level this year, it still appears to be experiencing a solid growth rate. Looking at some other metrics, household debt is at 89% and public or government debt-to-GDP is at 54%. While those readings may seem high to some observers (and higher than they were in 1997 during the Asian financial crisis), both readings are actually less than that of the US.

Malaysia's trade surplus is good (which not many countries can boast) and foreign reserves remain at a healthy level. We also believe Malaysia's demographics represent a positive factor going forward, as its young population is entering its most productive years and represents a big consumer market. I think the country has much more potential in many consumer sectors, as well as in tourism.

If economic fundamentals do not seem to be signalling crisis, it seems that political scandal has been more likely behind the flight of foreign investors from Malaysia. The default of 1Malaysia Development Bhd (1MDB) and related political scandals affected investors' sentiment and confidence. However, foreign investor flows are often short term in nature and temporary.

Negative news certainly affects investor confidence but we generally see these periods of market overreactions as opportunities — if we find reasons for a recovery long term. We find a number of sectors to be attractive in Malaysia today, including integrated oil companies involved not only in production but also exploration, refining and marketing, as well as companies involved in the consumer sector.

Our strategy has been to focus on the long term and not get sidetracked with individual news items; that's something we strive to do in any market we invest in. 1MDB is not the entire story of Malaysia's economy — although positive resolution should help foster improved investor sentiment.

The proliferation of the Internet and smartphones is accelerating change, including bringing corruption to light in many countries. Exposing corruption and scandals publicly can help bring about positive longer-term changes — hopefully that is the case for Malaysia and 1MDB.

Meanwhile, Malaysia continues its efforts in the area of Islamic finance. I found Bank Negara Malaysia governor Datuk Muhammad Ibrahim's comments at the GIFF quite interesting in regard to how new technological innovations could take Islamic finance to the next level of development.

He spoke of how the digital revolution and widespread penetration of technology-driven applications were already present in nearly every segment of the financial sector, and that so-called "fintech" innovations have been fundamentally altering the way we experience and deliver financial products and services. This is something I have also been talking about for some time. Emerging markets are experiencing a technological leapfrogging in many areas; the adoption of new technologies is moving very fast.

One example is in the area of mobile banking and electronic payment systems, which are growing worldwide. In Malaysia, the first Islamic Shariah-compliant Internet-based banking platform, called the Investment Account Platform, was launched this year.

Formed by six Islamic banks in Malaysia, it utilises technology to efficiently channel funds from investors to viable economic ventures, promoting risk-sharing and supporting cross-border investments. This is just one example of how new technologies are shaping the Islamic world, and the world of emerging markets.

Extracted from an article by Mark Mobius, the executive chairman of Templeton Emerging Markets Group.

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