The Potential for Fund Management in the Middle East

24 August 2008

Dr. Nasser Saidi

Chief Economist

Dubai International financial Centre

Agenda

DIFC

- Mutual funds – Overview
- Regional Asset Management
- Opportunities and Challenges
- Opportunities for Hedge Fund Managers
- DIFC Value Proposition

Mutual Funds – Overview I

- Mutual fund industry has enjoyed explosive growth in the number of funds, the types of funds available, and total assets under management.
- Percentage of households that directly or indirectly own stock in publicly traded companies increased dramatically over the past decade.
- Mutual funds have become an increasingly important asset component of households' savings and retirement accounts.
- Significant number of U.S. households own funds: assets in U.S.-registered investment companies—mutual funds, exchange-traded funds (ETFs), closed end funds, and unit investment trusts (UITs)—totaled $12.2 trillion as of mid-year 2007. Households held about 84 %, or $10.3 trillion, of all of these fund assets.

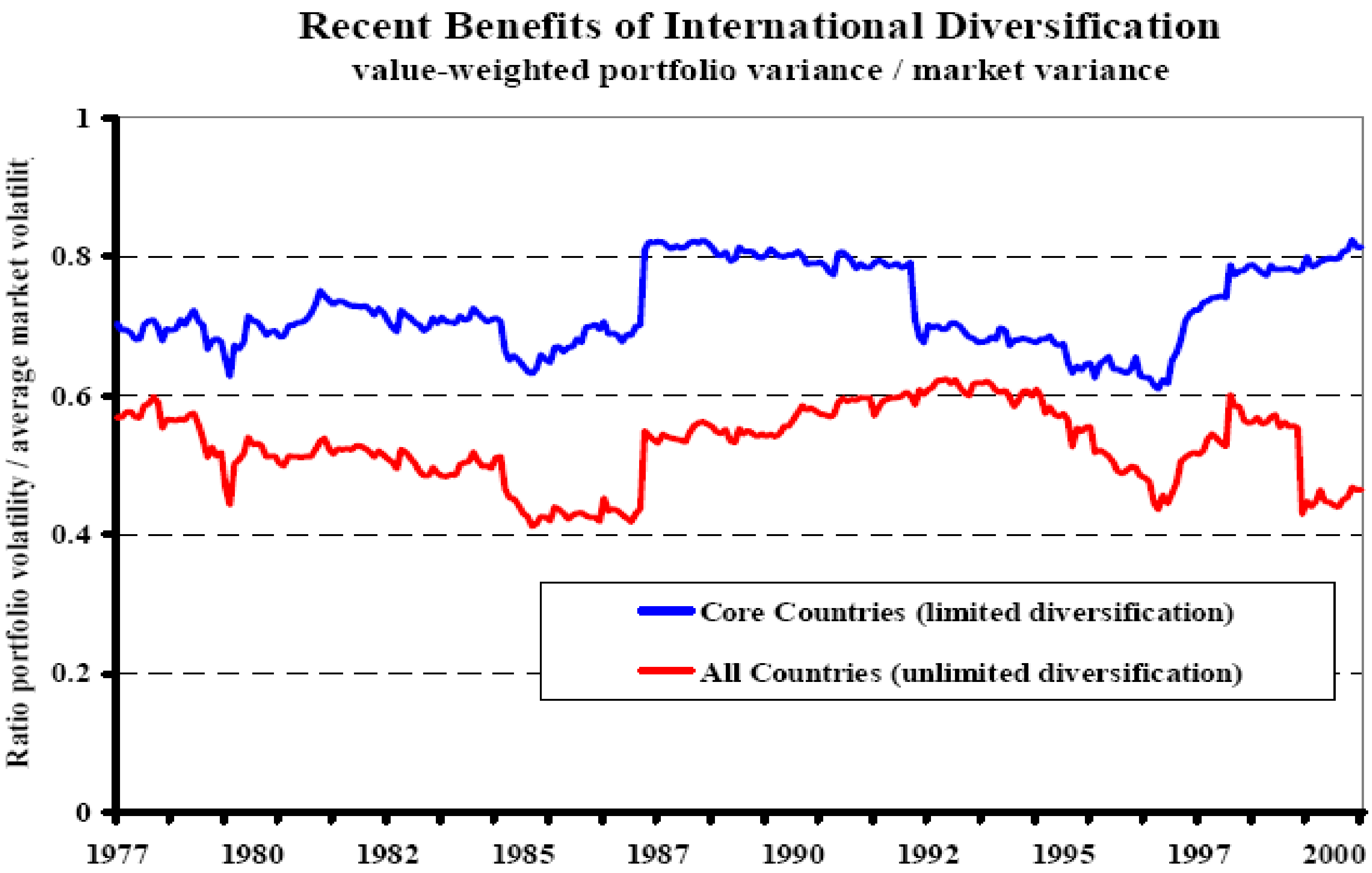
Source: Investment Company Institute

Mutual Funds: overview II

- **Benefits**:
  - Liquidity
  - Diversification
  - Accounting & record keeping
  - Choice & flexibility
  - Index-tracking

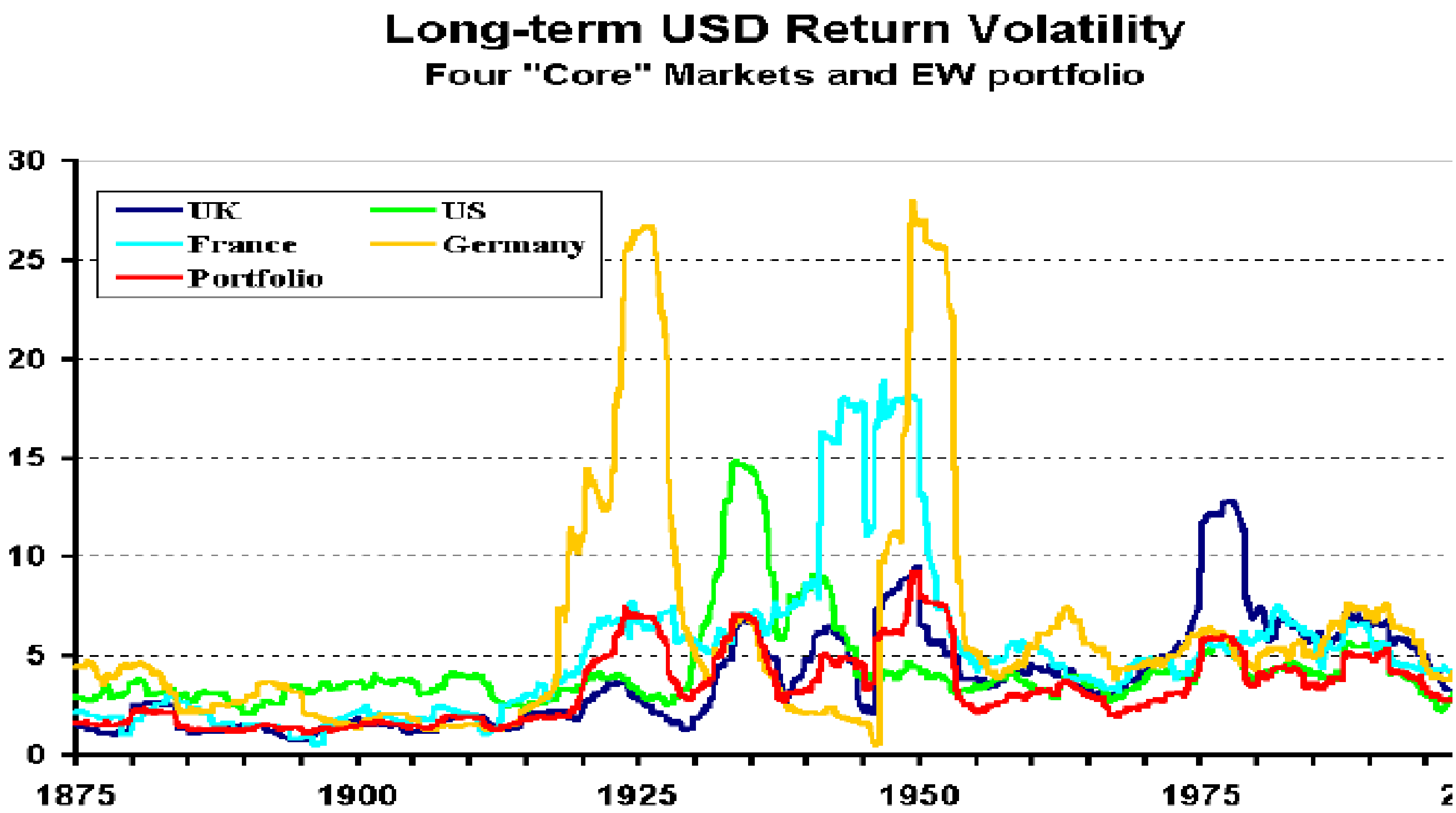
- **Drawbacks**:
  - High fees: front-end, management, performance etc.
  - Transaction costs
  - Poor investment management performance
  - ‘Churning’
  - Taxes

Mutual funds – diversification benefits



Source: Long-term Global Market Correlations" , W. Goetzmann, L. Li & G. Rouwenhorst, IMF Global Linkages Pre-Conference, 2002.

Long-Term Benefits of Diversification



Source: "Long-term Global Market Correlations" , W. Goetzmann, L. Li & G. Rouwenhorst, IMF Global Linkages Pre-Conference, 2002.

Diversification benefits

- Diversification benefits can be measured by the ratio of:
  - Return variance of a diversified portfolio
  - Average return variance of the assets in the portfolio

- Some important insights of diversification:
  - Maximum global diversification offers 65% -75% risk reduction
  - Expansion of opportunity set contributes about half of the total diversification benefits
  - The increase in the number of markets: risk reduction rises from 50% to 65%-75%
  - Despite the slow rise in return correlations due to increased integration, the benefits to international diversification have been remarkably stable over last 25 years
  - Emerging markets have lower correlation than developed markets: risk reduction rises from 30% to 50%
  - Emerging markets double the benefits to diversification across core markets.

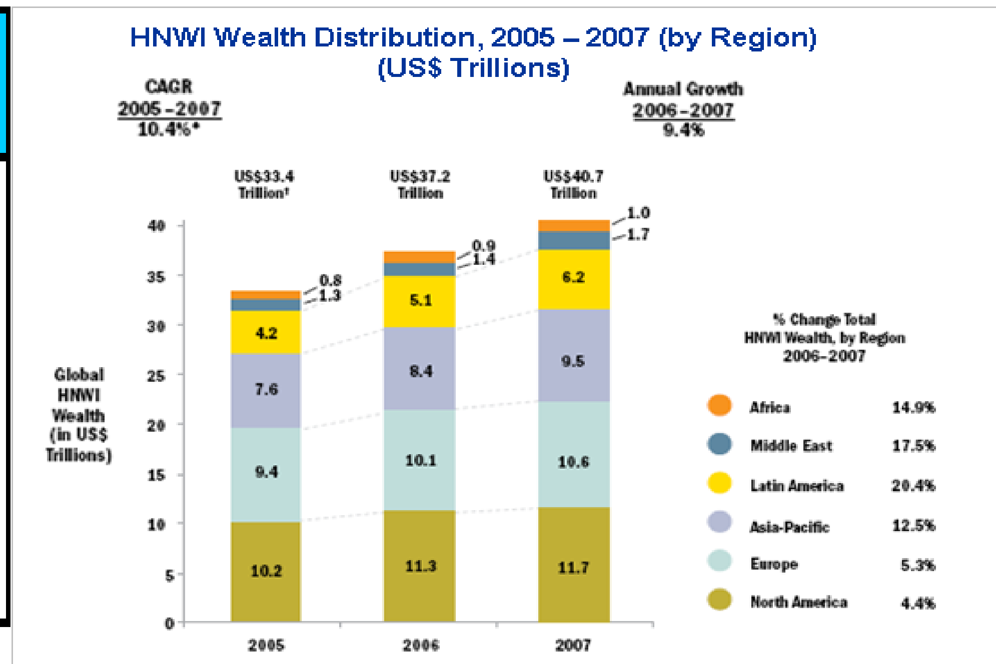
Source: "Long-term Global Market Correlations" , W. Goetzmann, L. Li & G. Rouwenhorst, IMF Global Linkages Pre-Conference, 2002.

Regional Asset Management

- Mass-market asset management industry in the GCC remains relatively small and has room for major growth and development.
  - In 2006, GCC region has an estimated US$60-65 billion of AUMs, of which US$52 billion are spread across some 500 funds.
  - Saudi Arabia is by far the largest market with over half of regional funds.
  - UAE is estimated to currently have about US$6.5 billion of AUMs. Real estate funds have registered the most prominent increase in size, from an average of US$45 million in 2004 to US$1.9 billion
  - In comparison total AUMs registered by Singapore based asset managers (US$814 billion)

	Mutual funds AUM as % of GDP	Money supply as % of GDP
Bahrain	50.1	67.6
Egypt	7.9	40.5
Kuwait	10.6	59.6
Oman	0.8	39.5
Qatar	1.1	45.5
Saudi Arabia	5.5	46.6
UAE	1.5	77.5

Source: Cerruli Associates, Reuters Ecowin, DIFC estimates



Source: Shuaa Capital 2007 research, Zawya Mutual Funds Monitor, Merrill Lynch

Opportunities: Structural & Policy

- Strong Growth prospects, infrastructure investment, economic diversification and increased openness: new investment opportunities
- GCC Common Currency: strong capital market expansion and creation of money market funds
- Growth of Islamic Finance and Islamic Fund Management
- Privatisation and PPI provide major opportunity for market growth
- GCC and MENA are Emerging/Nascent markets: provide diversification benefits for international and regional investors
- The growing number of new Sukuk issues, IPOs and corporate restructurings are a barometer of the transformation that is gradually taking place.
- Middle East is predicted to be the fastest growing region for HNWI assets (15.3% per year). With mutual fund penetration rates at very low levels across the GCC, there is tremendous opportunity for growth.

Source: Shuaa Capital 2007 research, Zawya Mutual Funds Monitor

Opportunities: Industry & Market

- Opportunity for international players to introduce a new mix of products tailored to regional investors‘ appetite and risk requirements: real estate and infrastructure funds, REITs, pension funds, Islamic structured products, fund of funds and ETFs
- Opportunity for ‘white labelling’, and third party distribution
- Real estate remains by far the preferred asset class for regional investors as a result of strong cultural bias towards investing in physical assets or direct business transactions.
- Its expected that more international institutional investors will enter the regional market, and this will bring not only a fresh pool of funds into the market, but also much needed technical knowledge.
- The GCC mutual fund industry is estimated to grow to $160 billion by 2010. Market knowledge, sophistication of investors and appetite for financial services is increasing.
- Build institutional investor base: Liberalisation of insurance industry and of pension funds can grow the industry to $250 billion by 2010

Role of DIFC in promoting Mutual Funds

DIFC

- A visible trend in the Gulf region during the period 2005-2006 was the large participation in the stock market run, with almost no diversification of asset-base.
- Given the volatile nature of the equity markets in the current global backdrop, mutual funds can act as a good vehicle for diversified investment – especially for small household investors and funds with no front-end fees.

- **As of Q1 2008, over 1400 domestic and foreign funds were marketed and sold in the DIFC:** highlights the potential for using DIFC as a platform for distributing funds in the region.
- Two broad strategies:

(a) Fund management industry in the GCC region and at the DIFC needs to be nurtured so that fund registration, administration and management is undertaken locally, as opposed to the current practice of only marketing foreign funds to HNWI in this region

(b) Greater participation of the mutual fund industry by encouraging them to invest in bonds, Sukuk, stocks from the region.

DIFC Value Proposition

DIFC

- DIFC offers fund managers an opportunity to access regional market from a single platform.
- DIFC funds legislation permits both the domiciliation of funds in DIFC and or distribution of existing foreign funds.
- DFSA funds regime in compliance with IOSCO Principles for Collective Investment Schemes.
- Flexible legislation allowing for **delegation and outsourcing of functions to third parties** that do not have to maintain a presence in DIFC.
- **Favourable tax structure** and a wide network of **double tax treaties** enabling hedge fund managers and their customers from around the world to optimize on the tax impact of DIFC domiciled funds.
- DIFX developing and harmonizing indices and benchmarks for measuring and reporting performance of funds.
- **No exchange controls** resulting in greater investment flexibility. Some domiciles restrict investments through local exchange control regulations, thus reducing the potential of an international investment portfolio. UAE does not impose any currency or exchange controls that would inhibit international investments.

Opportunities for Hedge Fund Managers

- Growing investor appetite for alternative investments among both high net worth individuals and institutional investors looking for diversification of their portfolios.
- The **introduction of new financial instruments** like futures contracts, short selling and index products in regional stock markets will further facilitate growth of hedge funds in the region.
- **Right size regulation.** DFSA regulates fund operator rather than fund itself, with focus of regulation on risk management, leaving **room for product innovation.**
- **Lower cost of compliance** for operation of hedge funds
- Hedge fund managers can benefit from **tax advantages** by domiciling funds in DIFC, especially for short term strategies where taxation acts as disincentive and deterrent in other jurisdictions.
- No investment and borrowing restrictions of DIFC domiciled hedge funds.
- Availability of substantial **regional real estate** and **commodity investment options**.
- Hedge fund managers do not have to deal with stigma and perceived negativity of being offshore. DIFC is a **recognized onshore jurisdiction** with a regulatory framework inline with international best practices.

Challenges for the Region

- Weak corporate governance
- Depth and breadth of local talent is limited
- Gaps in specialized skill sets (structuring funds, REITs, Trusts, Islamic Funds)
- Lack of institutional investors and absence of exit strategies
- Barriers to entry and low percentage of free float restricting foreign institutional investor participation
- Absence of relevant benchmarks for performance measurement: adopt CFA Institute's Global Investment Performance Standards (GIPS)
- Absence of a regulatory framework that promotes and encourages introduction of new products
- REITs - issue with foreign property and asset ownership restriction in UAE and wider GCC (title ownership over assets)