Alternative investments prepare for lift-off

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From an economic and investment viewpoint, the Middle East has long been a part of the emerging markets strategy of major global funds, and, over the years, it has provided significant returns as the region's economies grew rapidly. Then, along came the financial crisis that shifted the economic groove from the West to the East, making the Middle East even more attractive for wealth creation.

Now, opportunities are knocking and tremendous growth potential and alpha creation – spanning over the next five to ten years – awaits the industry. But as the region comes to grasps with what lies ahead, it is still awaiting the big boost in demand that is needed to set the wheels in motion.

However, experts maintain that when, and not if, the demand comes in, industry participants need to ensure that there is the infrastructural capacity, skill and regulations in place in order to be able to take full advantage of these opportunities.

One of the biggest incentives for hedge funds to take advantage of at the moment comprises the volatile and depressed markets in the Middle East. At the height of the financial crisis, Middle East markets witnessed one of the sharpest falls ever. And they are still recovering. But, as they do, a growing number of investors – regional and international – are seeking to manage their risk via hedge funds.

Marc Hambach, chief operating officer of Gulfmena Alternative Investments, says that today's markets represent a typical time when market inefficiencies are at a peak and, thus, is an ideal environment for hedge fund managers. "This incentive [of volatile markets] is extremely strong, especially within absolute return funds which can deploy several trading strategies that can take advantage of momentum and sentiment-driven volatility, arbitrage, convertible arbitrage and price distortions."

Eric Swats, head of asset management at Rasmala Investment Bank, says that Middle Eastern markets are also useful for international alternative investment managers looking to add beta to their portfolios. "Asian and Latin American markets have performed much better than their Middle Easter peers this year, and as such, global investment managers have been focusing their attention on those better performing markets. "However," he adds, "the MENA equity markets continue to offer good value, and we would expect international investors to rotate out of those markets which have become expensive and into the MENA markets."

Indeed, the asset management and private equity sectors of the market are not new to the Middle East and have been very successful for a number of years. But the hedge fund space in the region represents less than 2% of the asset management industry and therefore has tremendous potential for growth.

While there have not been a significant amount of new developments in the alternative asset management sector in the Middle East over the past year, a conservative stance from an investment viewpoint seems to be the order of the day. Most investment managers implement long only equity strategies for their clients and that remains the case today.

With many investors and managers still bruised from the sharp fall in equity markets at the end of last year and beginning of this year, experts say that fixed income strategies and sukuks (an Islamic financial certificate, similar to a bond in Western finance, that complies with Sharia, Islamic religious law) have become more interesting, as investors have a greater preference for conservative investment strategies at this time.

David Morrissey, director of business development of SEI's Investment Manager Services division, foresees fixed income becoming more popular (under Shariah rules or otherwise), as investors focus on diversifying portfolios. Swats adds, “Conservative investment strategies like fixed income and Sukuk funds are likely to stand out in 2010 as investors remain cautious.”

Considering the lack of appetite for risky strategies, many experts see plain vanilla absolute return funds as those that will flourish first. Hambach explains, “Given the limited universe of shorts and derivatives in the region and the increased level of risk aversion, absolute return strategies will represent the bulk of the new products that will stand out. Unlike market neutral or other advanced strategies, absolute return strategies can be opportunistic in the use of shorts and derivatives.”

Other products that stand out are Ucits and private equity funds. John Alshefski, senior vice president at SEI’s Investment Manager Services division, says, “Ucits in particular are seen as attractive products, given their regulated structure, and there is active work occurring to determine whether Ucits funds can be marketed in the Middle East as well.”

Many within the industry are expecting a bounce back in the private equity market. Hambach adds that other products that will stand out within the non-traditional space are distressed real estate funds and special situations for equity investments, including private equity funds.

The biggest change and focus for the asset management and hedge fund industry, however, is the issue of regulation. Rapidly growing investor sophistication, especially following the credit crunch, places compliance and regulation at the crux of any successful investment strategy.

As transparency and well-conceived regulation are welcomed globally, there is much similarity between the outlook for the Middle East and that across Europe with regards to regulation and compliance. In fact, Alshefski says that the Irish Funds Industry is eager to help the Middle East region develop and is working with the local regulators on the same.

Hambach views regulation as a positive development for the region. “Now that regulatory authorities like the Dubai Financial Services Authority (DFSA) supervise and enforce stringent regulatory regimes (which are at par with world class jurisdictions) on authorised firms in the Dubai International Financial Centre (DIFC), an increasing number of fund managers will choose to be based in such jurisdictions. This will allow them to tick the box of compliance and adherence to well defined and strict laws and regulations.”

Despite this, Swats believes the regulatory environment limits the investment managers’ options, e.g. no shorting of securities. “Until the regulatory environment moves forward, the ability to implement hedged strategies will not materialise,” he explains.

It has also been said that because of its regulatory environment, the DIFC will be in the long term successful in attracting asset managers that aim to be regulated. Earlier reports have mentioned DIFC, with its new legal framework, being able to attract business away from the Cayman Islands, for example. “With regard to funds’ domiciliation, however, there are some challenges facing this endeavour because of passportability. However the DFSA is currently reviewing its fund regime with the input of practitioners which will hopefully lead to a more attractive regime,” Hambach clarifies.

Little less than a decade ago, fund management in the Middle East was under-developed and there were many more hedge fund products managed out of the region than those sold into the region. But back then the number of fund managers was very limited while today there are more than 100 asset managers and over 500 mutual funds (home-grown funds) with around USD65 billion in assets under management. As such, the foundation for further growth in the industry has already been laid.

The funds industry in the Middle East has sparked much interest from leading participants globally who have identified that they are able to access and sell the products throughout international markets. One must differentiate between Middle East managers located outside the region, Middle East managers located locally and selling to investors outside the region, and Middle East managers located locally and selling to local investors.

In all cases, the outlook is very promising. The region boasts the highest GDP per capita in the world which translates into the fastest growing household and investments savings in the world. “These,” says Hambach, “will require sophisticated advice, products and services going forward. While the region is at USD65 billion in assets under management, it is still short of its peers such as Singapore, Malaysia and other emerging markets – where the industry sits at around 25% of market capitalisation compared to less than 10% in the Middle East. This signals tremendous double digits growth potential in the industry over the next five to ten years.”

Growth will be driven by the absence of large players in a market which has less competition. As Swats explains, “The potential size of the [funds] market is very large. The actual market declined along with the equity markets. Now, there are fewer competitors than a year ago as several of the larger players have had negative corporate developments holding them back.”

However, while supply within the industry is increasing, the market still requires a number of improvements such as private, public and pension fund reforms. Alshefski is positive but throws a warning sign. “As the industry continues to grow and become more established, as local stock exchanges become more mature, and more and more securities are created in which to trade, the industry participants need to ensure that there is the infrastructural capacity, appropriate investor protection and regulations in place, and generally demonstrate knowledge of industry best practices in order to be able to take full advantage of these opportunities.”

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