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Dubai Opens Its Shariah Hedge Fund to Investors

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NEW YORK—Dubai is opening up its inaugural hedge fund to investors after an index-beating debut.

The Middle East emirate's first fund of funds, which was launched at the beginning of 2009, beat comparable indexes by posting a 41% return last year. The fund, up slightly more than 1% through March 28, is still outperforming benchmarks this year.

Fund operator Dubai Shariah Asset Management, or DSAM, sees this as proof that a hedge fund based on Islamic law, or shariah, can provide similar or better returns than conventional hedge funds.

Portfolio managers at [BlackRock Inc.](#), [Tocqueville Asset Management](#), [Lucas Capital Management LLC](#) and [Zweig-DiMenna International Managers Inc.](#) were given an initial mandate to invest in commodity-company stocks that were screened to meet certain requirements. The \$260 million currently managed by the four is dubbed the DSAM Kauthar Commodity Fund, named after a river in heaven described by the Quran.

The hedge-fund experiment was a departure for the region's investors, who traditionally put money into real estate, private equity or long-only mutual funds. Hedge funds were shunned due to their secretive trading strategies, which often couldn't be checked for shariah compliance. But Islamic banks around the Arabian Peninsula, which have recently started or bolstered their asset management divisions after real estate prices collapsed, are starting to show interest.

Despite the debt woes of some of the region's major players, the Islamic-finance market is expected to increase 20%-40% annually over the next several years, fueled by more investment options and a growing appetite among Muslim investors.

A year ago, "it would have been a waste of time to talk about diversifying to other products" with banks because they were hooked on construction and financing properties, said Ahmed Bin Sulayem, executive chairman of Dubai Multi Commodity Center, an agency that owns a 51% stake in DSAM. "Right now, they are doing the opposite. They are not touching anything in properties."

The other 49% is owned by Shariah Capital Inc., a New Canaan, Conn., firm that developed software to ensure that investment activities are shariah-compliant. The fund's largest positions include [Massey Energy Co.](#), [Osisko Mining Corp.](#), [Plains Exploration & Production Co.](#) and [Peabody Energy Corp.](#) None of the money managers comprising the funds of funds are permitted to take on debt to boost returns.

While real estate was popular with shariah investors due to their preference for visible, long-term assets and a surge in shariah-compliant debt financing, the Dubai World debacle exposed the risk to an investment approach that was perceived to be conservative. Mr. Sulayem serves on the board of Dubai's flagship investment conglomerate, of which his father is chairman.

Last week, Dubai World—whose troubles rocked markets in November 2009—said it plans to restructure nearly \$26 billion of debt. Debt investments represent about a third of the roughly \$800 billion Islamic banking industry, which includes real estate, private equity, venture capital, insurance and other products.

DSAM is drawing interest from major Islamic banks that cater specifically to wealthy clients seeking investments that don't violate shariah. These investors avoid companies engaged in perceived vices such as gambling or alcohol. They also shy away from firms that rely on interest revenue or that carry heavy debt burdens. Short selling, or selling a borrowed stock in hopes of repurchasing it at a lower price, is also prohibited.

Bahrain-based Gulf Finance House confirmed that it was in talks to start offering the fund to its clients.

"There's very little awareness still about hedge funds" and it could take several months to make investors more comfortable with the concept, said Hani Redha, executive director of the recently formed asset management division at Gulf Finance. "The idea is to coax [the investors] to move just a little bit further out into the risk spectrum."

Other Islamic banks in Dubai, Bahrain, Kuwait and Saudi Arabia are considering making DSAM's funds available to clients, said Shariah Capital Chief Executive Eric Meyer. The minimum investment is \$5 million, and banks can customize their offerings.

Dubai Shariah Asset Management is staking its success on three innovations. Mr. Meyer, a practicing Catholic and former technology-hedge-fund manager who closed shop before the 2000 bubble burst, worked closely with Islamic scholars to develop trading software that uses a more sophisticated approach to screening credit worthiness.

This increased the pool of U.S.-traded stocks meeting Islamic law to 4,700 from about 2,000-3,000. Fund partners DMCC and Shariah Capital plan to eventually bring in dozens of fund managers who invest in other sectors based on the success of the current fund of funds.

Second, Mr. Meyer's team designed a contract equivalent to short selling. The fee usually assessed to borrow a stock is treated as a down payment for a security to be purchased at a later date. This "arboon" contract, as it is known in Arabic, is a common contract shariah-conscious consumers use to purchase automobiles and other big-ticket items.

Third, Shariah Capital's trading software comes with back-office services built in. Barclays Capital serves as the custodian and prime broker and Citco Fund Services is the administrator.

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