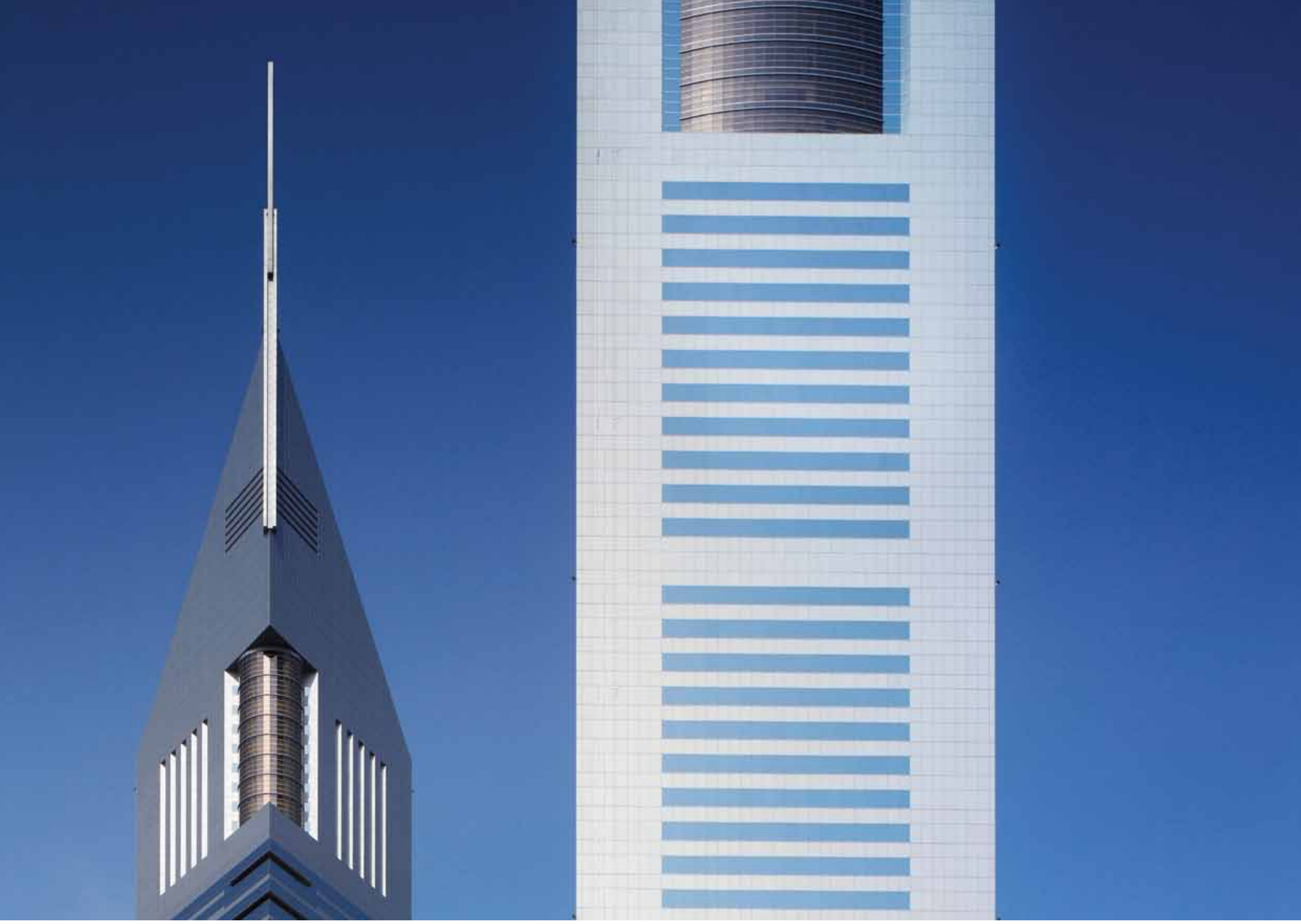

Selling Promise:

How Can Middle Eastern Managers Raise Investor Interest?

A Research Paper on the Middle Eastern Asset Management Industry

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Today, investors increasingly place a primacy on identifying growth markets, especially as forecasts for growth are quite bleak in developed economies. For more adventurous investors, the Middle East offers some compelling opportunities, though the region does pose some special challenges. For asset managers specialising in the region, a critical question is, how should one maximise investor interest in a region that is largely misunderstood?

In this whitepaper, Citi and ING Investment Management highlight some of the challenges foreigners face when attempting to invest in the region, including limited liquidity, lack of understanding of the region and competing demands for capital. However, we believe that through investor education, flexible portfolios and openness to alternative distribution channels, Middle Eastern mangers can overcome these hurdles and grow their business.

Lack of Retail Investment Hurts Institutional Investors

Any investment strategy focused on the convergence between developed and emerging nations would have to consider the tremendous potential of the Middle East.

The combination of favorable demographics – a fast-growing population with 60% under the age of 30, and access to some of the largest oil reserves – gives hope to a region that has not always kept up with its emerging market peers. However, even before the recent "Arab Spring" – a series of protests and uprisings sparked by events in Tunisia and Egypt – investment in the region has had its challenges. One manager we spoke with claims that foreign participation in the Egyptian stock exchange has dropped from 30% to 6% after the crisis.

One challenge for both domestic and foreign investors has been the comparatively small size of the collective fund marketplace in the Middle East. The small size of the local retail fund industry also has an indirect impact on institutional investors, as the industry has lacked the critical mass to foster regulatory oversight and more investor-friendly operational structure.

While private banks active in the region offer sophisticated investment advice, the mass-market is still developing. Some describe the retail market as polarised, with short-term traders juxtaposed against those who sit in cash and shun the market entirely. "Retail banks tend to collect more deposits than anything else," notes one manager active in the region. Arguably, a market exhibiting a combination of herd mentality and nonparticipation is an inefficient one, suggesting ample opportunities for active managers to add value.

Whether measured in absolute size or relative to GDP, fund ownership in MENA countries is low. According to a study conducted by the World Bank, fund assets in the 15 MENA countries totaled just USD67 billion as of year-end 2009 – about the same size as Austria or Mexico. The same study estimates that equity funds account for just 2% of MENA-wide market cap, compared to averages of 5% for Brazil, South Africa and China, and 10% to 15% for most developed markets. In addition, 94% of fund assets within MENA are focused on investing solely in the country where they are domiciled.

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	Number	Assets Under Management			Average Size
		USD Millions	% Total	% of GDP	USD Millions
Bahrain*	134	5,580	8.3	25.5	41.6
Egypt	59	8,735	13.0	4.6	148.1
Jordan	3	17	0.0	0.1	5.7
Kuwait	65	5,514	8.2	5.7	84.8
Lebanon	13	352	0.5	1.0	27.1
Morocco	294	21,552	32.1	23.4	73.3
Oman	9	191	0.3	0.4	21.2
Qatar	9	122	0.2	0.1	12.3
Saudi Arabia	153	21,464	31.9	5.7	140.3
Tunisia	88	2,889	4.3	7.2	32.8
UAE	27	785	1.2	0.3	29.1
Total/Average	**854**	**67,201**	**100**	**6.7**	**78.7**

* Source: The World Bank, Investment Funds in MENA (Dec 2010). Local funds only: per World Bank analysis, excludes "authorised funds", which resemble private equity.

According to the paper's authors, the results of having a small fund marketplace are threefold. First, low retail ownership of equity funds (relative to market cap) makes stocks less liquid, even when compared to other frontier markets. Second, the low percentage of fund assets (again relative to market cap) reduces pressure on corporate management to observe good governance. And third, the lack of critical mass has held back the smooth functioning of asset valuation and securities settlement. To wit, only 31% of MENA funds provide daily NAV updates, with around 17% striking a value just monthly or even less frequently. There may be a "Catch-22" phenomenon at work here: the smaller size of the asset management marketplace doesn't justify the cost of improving the operating environment, yet unless the operating environment is improved, many participants (investors, managers, and service providers) may choose to do business elsewhere.

The development of a thriving retail fund market would improve liquidity, corporate governance, and improve market infrastructure—all of which would benefit both retail and institutional investors. Local sovereign funds have a clear mandate to diversify away from hydrocarbons, yet their sheer size makes investment in some securities highly problematic in the short term.

How Keen are International Players?

Foreign investment in the Middle East has been constrained by a number of factors, including lack of access, lack of understanding of the region and competition from other destinations.

For some institutional investors, a key barrier to investing in the Middle East is the region's complexity. "Some international investors tend to think of all countries in 'blocks,' " notes one CEO active in the region, "as if all GCC [Gulf Cooperation Council] countries are one." That sentiment was echoed by a global consultant, who remarks that clients are sometimes unaware of the differences from country to country, assuming that all of the economies are underpinned by oil production, or that all of the countries do not have a stable political climate conducive to foreign investments.

Arguably, investing in dedicated Middle East mandates may represent an extreme point in the evolution of international investing, which has morphed from developed to emerging to frontier and regional mandates. Yet, it's worth recalling that shedding home-country bias is a relatively recent phenomenon for institutional investors, particular in large markets such as the US, fostered perhaps by the luxury of an investable universe well diversified across sectors and capitalisation ranges. Many institutions have only in the past few years considered investing in emerging markets, an idea clearly supported by their growth potential. But the lower debt levels of many emerging economies have suddenly led to a reexamination of the long-held belief that developed countries are much safer than emerging ones.

Unfortunately for managers of Middle Eastern mandates, this does not automatically translate into flows for regional mandates. One barrier may be the fact that when it comes to regional strategies, investors have been much more interested in Asia-focused EM strategies. A review of US-domiciled retail funds shows that assets in Latin American focused funds and ETFs total approximately USD40 billion, outnumbering Middle Eastern focused fund assets by more than seven to one. Comparing allocation across the four groups below shows that MENA funds account for approximately 5% of the roughly USD100 billion invested in regional emerging market funds.

	Number of Funds	AUM (USD)
Asia, excluding Japan	47	39,775
Latin America	28	29,763
China focused	40	25,250
MENA focused	24	5,364

* Sources: Strategic Insight, Lipper. Notes: includes ETFs. Since Lipper does not have a dedicated Middle East category, funds with "Middle East" or "MENA" in the name, or large exposure to the region, are included.

In the short run, political risk has reached a fever pitch, "the exact opposite of the headline risk pension plans want to avoid," laments a European consultant, whose firm received dozens of enquiries from institutional clients concerned about their limited exposure to Egypt through emerging market mandates.

But setting aside the events of the recent Arab Spring, "there is certainly less appetite for Middle Eastern mandates than for Asia," observes one consultant very active in the region. The fact that countries such as Japan and China are top-five economies makes Asia too large to ignore for many institutional investors, while the Middle East lacks an "anchor" market of this magnitude. (We should also note that Hong Kong's history of colonisation has been a primary driver in helping it to become a financial centre with Western-style investor protections.) Additionally, Westerners are less likely to have set foot in the Middle East, as tourism data shows that four times as many US travelers made the journey to Asia during the past year.

More broadly, however, few institutions have much appetite for regional mandates anywhere. Although the interest in emerging and frontier mandates is strong, "regional investing in general is not common for institutions," says one European consultant, further noting that "even Asia or BRIC mandates are rare." Furthermore, although Asian and European sovereign wealth funds are indeed active investors in the Middle East, "they have typically selected 1, 2 or 3 countries they want to invest in," explains one local manager, as opposed to investing in the region as a whole.

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Packaging Countries and Defining the Mandate

Even when there is an appetite to invest in the Middle East, there is no general consensus on how to define or benchmark such mandates.

Even when there is an appetite to invest in the Middle East, there is no general consensus on how to define or benchmark such mandates. Whereas BRIC or Asia ex-Japan offer readily defined benchmarks, Middle Eastern mandates can be defined as GCC and Middle East and North Africa (MENA), with the latter also occasionally expressed as "MENASA" to include South Asia (India and Pakistan). Further complicating the definitions are uniquely Arab terms such as Magreb (referring to the North African nations spanning from Libya westward to Mauritania) and Mashriq (countries running east of Egypt and towards Iran), as well as the Levant, a loosely defined strip of land encircling the eastern edge of the Mediterranean, including parts of Turkey. Investors might also define the region based on oil- versus non-oil-producing countries, and wrestle with whether to include Saudi Arabia (generally inaccessible to foreigners), Israel or Turkey, the latter two of which are considered more European, or at least not Arabic in the traditional sense. Although most managers and investors typically see less opportunity in Yemen, Libya or Syria, the latter two countries had seen an increase in foreign direct investment up until the recent crisis.

Theoretical arguments aside, benchmarks offer an interesting view into how investors might access the region. For example, the MSCI Frontier Market index – in theory a global index – is actually "about 70% comprised of Middle Eastern countries, yet Egypt and Saudi Arabia are excluded," explains one manager in the region, with the former inaccessible due to capital controls, and the latter being a component of the Emerging Market (rather than Frontier) index. Furthermore, since the commonly accepted indices use available free-float and market-capitalisation weightings to best reflect the liquid, investable universe, one country, Kuwait, can represent more than 30% of the entire index – perhaps not the best benchmark for active diversified managers.

Concentration at the stock or sector level is also a problem: financial services account for 48.8% of Russell's Frontier Index, according to the firm's website, and 59.7% of the Russell Frontier Middle East Region, as of September 2010. Meanwhile, 71.1% of Bahrain's representation in the Russell Frontier Index is comprised of one security, Mobile Telecommunications Company KSC. Investors may have to accept concentration, while managers may have to accept limited liquidity.

Yet another consideration for managers and investors is how to define the "African" component of any would-be regional mandate. For example, some have argued that MENA is a construct losing its usefulness, since the dynamics of the Middle East are starting to differ from the rest of North Africa. "The situation parallels what has happened with Mexico and Brazil," notes one global consultant, referring to the fact that the former is highly dependent on trade with the US, whereas the latter exports heavily to Asia. With respect to MENA, investors are increasingly recognising that the dynamics driving returns come from different sources; to best harness links with the China story, or to identify domestic consumption stories, many experts point to sub-Saharan countries such as Nigeria and South Africa as ripe for future growth. With a population of 140 million, deep natural resources and a society moving from subsistence to consumption, Nigeria is often referred to as "the Brazil of Africa." South Africa, in turn, enjoys one of the most sophisticated stock exchanges and a robust asset management industry, yet also displays many of the population and consumption dynamics consistent with high-growth economies. Thus, managers ignoring these two countries risk forgoing some investment opportunities, and may need a compelling argument to defend that decision, particularly with institutional investors.

Population, hydrocarbons and sovereign wealth mean that MENA matters. Yet for investors in the Middle East, it is fair to say that the region poses special challenges not faced even in other frontier and emerging markets.

For this reason, managers trying to market regional portfolios may wish to consider the following approaches to maximise distribution.

Craft an Education Campaign to Combat Misperceptions and Tell a Unique Middle East Growth Story

As noted above, clients outside the region often have little direct experience with the Middle East, and if they ever consider investing, they do so with preconceived notions at best (or stereotypes at worst). Current concerns about its finances aside, Dubai's stellar growth exemplifies the type of modernisation the region is currently undergoing. Managers should consider educational pieces that highlight the key differences of countries in the region, considering both economic and societal factors. "You need a dashboard for political risk," advises one European consultant, so that clients can better understand the structure and relative stability of regimes at a glance, without having to become political historians.

More importantly, before managers can tell the Middle East growth story, they need to write one. While critics decry the limitations of BRIC, CIVETS, N-11, Chindonesia, or the growth acronym du jour, these constructs do an excellent job of marketing an effective growth story, usually based on young, growing populations undergoing liberalisation. We suspect a similar story could be crafted for the Middle East. PEI Research has even argued that through IFRS accounting standards and English-language reporting, investing in MENA has advantages over other emerging and frontier markets. But until institutional investors are told a compelling story as to why they should invest in the region, many will make the easy choice and stay away entirely.

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Be Flexible with Mandates and Open to Partnerships

In highlighting the limitations of frontier benchmarks, one Middle Eastern manager wonders aloud, "What has Vietnam got to do with Egypt or Saudi Arabia?" It's a fair question indeed, but in the short run, it may make sense for regional managers to be more accommodating with these benchmarks, if in fact they are embraced by institutional investors. The immediate downside, of course, is that managers with Middle Eastern expertise may not be able to add alpha in far-flung markets such as Colombia or Vietnam. We see three possible compromises: convince clients to accept deviations from frontier/emerging benchmarks, create custom Middle Eastern region benchmarks, or consider partnering with Latin American and Asian managers to deliver global developing country mandates. Broader emerging mandates also make sense, since individual investment opportunities may abound, if even MENA mandates face some challenges. Favorable demographics may, to coin a phrase, cause a rise in boats (i.e., individual securities), rather than tides (i.e., regional performance).

Managers wishing to tout local expertise in the region may also wish to consider multi-asset mandates. As one local manager observes, "Most of the mandates we pitch for are absolute return-oriented," which might also give managers a longer leash in terms of being benchmark-agnostic. Moreover, to best combat the lack of sector diversification in many of the local listed markets, private equity expertise will prove useful to access family-owned businesses (which represent an astonishing 75% of the private sector, according to PEI) or to unlock value in "corporate orphans" (subsidiaries that have lost their strategic importance within the goals of the larger corporation) through a public offering. Expertise with infrastructure and real-estate investing are also a big plus, since both can offer favorable yield. Considering the importance of commodities to the region and the fact that oil companies are generally not traded, in short, managers should be open to deploying alternative strategies alongside traditional ones.

Potential Strategies for Distribution Success

Education	Combat misperception and craft a compelling 'Middle East story'
Flexibility	Consider broader emerging market mandates, or identify complimentary partners (ie: Asia managers)
Infrastructure	Press regulators and governments for changes to improve the shareholder experience
Goverance	Initiate a mutually beneficial governance dialog with corporate management
Start Small	Pursue ETFs and other retail strategies to build AUM and track record
Patience	Recognise the long-term promise but don't insist on immediate results

Advocate for More Robust Market Infrastructure

The chicken-or-egg phenomenon described earlier with respect to lack of operational infrastructure holding back the asset management industry is not likely to solve itself. Managers, investors and service providers alike should lobby local governments and regulators to make the necessary changes to make the market more fertile for both foreign and local investment. Loosening capital controls, offering incentives for technology investments, and raising minimum standards for trading and settlement are actions that regulators and governments could take in relatively short order. While loosening capital controls is always a risk for smaller economies, local governments will have to weigh the tradeoffs of currency volatility against the stability offered by increased foreign investment.

Encourage Best Practices in Corporate Governance

Companies controlled largely by governments or wealthy families may not exhibit best practices in governance. IPO distribution and other forms of financing may occasionally reflect nepotism rather than competitive bids. Asset managers would be wise not only to exercise negative election but to encourage corporate management to make changes as a precondition to initial or subsequent investment. Even in developed markets, conglomerates may trade at a discount, as analysts struggle to understand the drivers of earnings. By encouraging management to divest non-core businesses, asset managers can show management how it might unlock value, not only for the benefit of investors but also for the company.

Start Small: Consider Retail and Intermediary Opportunities

Given the laundry list of concerns that institutions have regarding Middle Eastern investments (benchmarking, political risk, operational standards) and the competing opportunities offered in Asia, Latin America and sub-Saharan Africa, local managers may wish to pursue a retail strategy. Such a strategy could include basic solutions, such as mutual funds and ETFs, which might be an easier sell through private bankers and financial advisers working with clients open to new ideas and less concerned with headline risks.

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A similar strategy could include working with funds of funds, multimanagers and subadvisory partners. While identifying long-term partners among these constituents does require some effort, these intermediaries are in good position to recommend a niche strategy, either because so doing is core to their mandate or because a Middle Eastern mandate could provide additional diversification to a multi-asset portfolio.

Focus on the Long Term

Managers plying Middle Eastern mandates clearly need to take an active role in building their business, both through client education and by identifying partners. That said, many are optimistic about the long-term potential of the region. Political unrest is definitely an issue in the short term, as one manager concedes, "The interest for Middle East strategies is definitely soft this year," especially relative to broader frontier strategies. A global consultant is also bullish, pointing to the fact that "a number of talented emerging market managers are closed or near capacity," which could cause institutions to revisit how they construct frontier and emerging portfolios. Referring to increased investments in the Middle East, he opines, "Further evolution might get [investors] there, but it will take time."

Longer term, there is a reason to be optimistic. Aid packages from the International Monetary Fund and G8 nations should help stabilise Egypt (with such sentiment having pushed up local stocks by more than 10% in May). And even the intricacies of market benchmarks could provide wind at the back of local countries, as MSCI is discussing both increasing its weighting of Qatar in its emerging market index, an increase which could further rise should South Korea and Taiwan "graduate" into developed markets.

Further down the road, Saudi Arabia is expected to open up to foreign investment. It is also conceivable that the intense competition between the Gulf States for dominance as a financial center will foster best practices in governance and market infrastructure.

While conceding some challenges, experts believe that the region exhibits a great deal of promise. "We think ME strategies will be back in vogue when investors start to realise that the region is still growing and that the political upheaval is not changing their long-term potential," claims one bullish manager. Investment opportunities abound.

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Investor acceptance won't change overnight, but with appropriate messaging, flexible portfolio construction and openness to new distribution channels, we believe that Middle Eastern managers should be able to grow their businesses considerably.

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