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Sukuk: Are they a safe haven?

By Tariq Qaqish, Deputy Head of Asset Management, Al Mal Capital.

Since the financial crisis hit world economies, risk aversion has been a key theme for investors. Over the past year, regional bonds and sukuk have witnessed much popularity where demand has consistently outpaced supply, specifically with issues that are backed by solid balance sheets.

As global troubles continue to disturb investors, GCC debt continues to attract strong inflows. This is no surprise, as the GCC sits on trillions of dollars in surplus. According to the Sovereign Wealth Fund Institute, Middle Eastern sovereign wealth funds accounts for 35% of the world's SWFs. Gulf countries such as Kuwait, Qatar, Saudi Arabia and the UAE are only raising funds for the sake of promoting domestic debt markets.

With the expectations of a low interest rate policy environment, we expect the asset class to continue in popularity. But to what extent should investors put faith in bonds and/or sukuk?

Having a Shariah structure does not mean sukuk are 100% capital guaranteed or safer compared to conventional bonds. Similar to bonds, sukuk are affected by the same risk factors such as interest rate risk. If interest rates go up, the value of sukuk (bonds) will fall. The direction of regional bonds and sukuk, for the most part, follow US bond as Gulf countries' currencies are pegged to the US dollar.

The perceived credit quality of issuers is another factor investors should look at. An example that illustrates this was the technical default of Nakheel 's USD 4 billion Ijarah Sukuk at the end of 2009. The Nakheel situation shook confidence in Islamic finance and restrained corporates from going to the market.

As the cost of insuring Dubai sovereign and quasi-sovereign debt (credit default swaps) hit the 650 levels, corporates/GREs had no choice but to pay higher profit rates to compensate investors for a perceived lack of credit quality.

The uncertainty over the level of protection for investors is also a key risk management decision. Some blame the ambiguity on the lack of a bankruptcy law and others admit that there is no standardization of Islamic finance. Companies that have defaulted on sukuk payments since the global financial crisis include: The Investment Dar, a Kuwaiti company, and the Saudi Arabian Saad Group.

A few days back, Dana Gas missed the USD 920 million sukuk repayment. While Dana Gas announced that it is in talks with creditors to amend the sukuk terms, others believe that creditors will go after the assets of the company. we are noticing that the latter investments are riskier than what meets the eye. When dealing with more risky sukuk/bonds, creditors should pay attention to the underlying assets that investors could claim against. In the case of Dana Gas , the sukuk is secured against the company's Egyptian assets as well as Sahaa Gas Private Ltd and United Gas Transmissions Co, part of A venture to supply Iranian gas to UAE. We do see value in the Egyptian assets, but we do not have an indication of how much the assets related to the Iranian deal are worth now as the project is stalled.

Another factor investors should look at is the real rate of return. In a high inflationary environment, investors should seek to invest in higher yields to compensate for the loss in purchasing power.

In addition to the global economic turmoil, political risk is an issue that plagues the region. The after effects of the Arab Spring have not only created the potential for political instability, but also put a damper on business in the region.

We encourage our clients to maintain a well-diversified portfolio and always look at the risk before taking any investment decision. Our Al Mal MENA Income Fund was shortlisted as the best performing fund in 2011 in its category by MENA Fund Manager. The fund has returned more than 11% to investors since the beginning of the year.

Tariq Qaqish has directed Al Mal Capital's range of equity products to top performer status since 2007, with both the Al Mal MENA Equity Fund and Al Mal UAE Equity Fund ranking as top performers in their respective categories. He previously spent six years with National Bank of Abu Dhabi where he managed two successful funds, the UAE Growth Fund and the UAE Distribution Fund.