INTRODUCTION

GAINING ACCESS TO A HARD TO REACH MARKET

The fund management industry has been busy launching products to gain exposure to the Middle East equity market. Elisa Trovato reports on a region where limitations on foreign ownership are still prevalent

The booming Middle East equity market is drawing increasing attention from investors and, unsurprisingly, there has been considerable activity in the fund management industry to launch products providing exposure to the region, which is typically excluded from global benchmarks.

Through emerging EMEA or more focused Middle East funds, these products aim to take advantage of the improved macro-economic environment of the territory, which benefits from a long history of high oil prices. Favourable demographics, solid earnings growth, strong liquidity and relatively attractive evaluations make the themes of infrastructure and domestic consumption very appealing in the region, say industry analysts.

But the looseness of the expression Middle East - a vast area with no clear boundaries, sitting where Europe, Africa, and Asia meet – shows in the variety of geographical coverage that the products available have.

JPMorgan Asset Management had a customised index created by MSCI for its Middle East equity fund, launched in 1998, in order to cover both Turkey and Israel.

"There are many definitions of the Middle East and there are many variations of indices with and without them. It is quite rare to find both Turkey and Israel in a Middle East index, and that is what customisation allows us to do," says Claire Simmonds, client portfolio manager in the emerging market equity team at JPMorgan.

Indeed, at over 70 per cent, these two countries represent the biggest slice of the JPMorgan Middle East equity fund. Israel is a more developed emerging market, which tends to be more defensive in nature, says Ms Simmonds. Turkey, on the other hand is a representative of longer-term secular themes. The Luxembourg-domiciled fund also invests in Egypt, Morocco and Jordan. Some investment opportunities are also found off index in Oman,

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Qatar and the United Arab Emirates (UAE). The index, says Ms Simmonds is only a loose tool for portfolio construction and it does not define the only opportunity set.

The fund, which currently invests in 60 companies, from 300 available in total, including off index opportunities, has "a strong emphasis on bottom up and top down fundamental research" and has gathered $650m (€425m), the majority of which is sourced from Europe.

"There is a strong interest from private and retail banks and increasingly so this year, given the performance last

year of the Middle East market and given the low correlation to global equity markets," says Ms Simmonds. According to her, the JPMorgan fund returned 46 per cent net of fees in US dollars last year, underperforming however its index which went up by 55 per cent. In its Luxembourg Sicav, JPMorgan AM also offers an emerging Europe, Middle East and Africa fund (EMEA) where the two largest weights in the reference index, the MSCI EMEA index, are Russia and South Africa.

Société Générale Asset Management has a different approach. In June last year SGAM launched a Luxembourg Middle East North Africa (MENA) open ended fund, which is a mirror of its closed end version, originally the SG Arab fund, established in 1997.

The MENA fund, which has gathered $550m in assets, predominantly invests in the Gulf Cooperation Council (GCC) countries, including Saudi Arabia, Kuwait, Bahrain, Qatar, the United Arab Emirates and the Sultanate of Oman.

"The six GCC countries encompass approximately 80 per cent of our investment today," explains Mark Krombas, fund manager, at the French firm. "Those are the countries which are very oil rich, are building their infrastructure, are not in any global benchmark and have only recently been opening to foreign investors." All of them speak Arabic, all of them have Arab heritage and all of them are Muslim, so there are very clear common ties that bind them together, he says.

The fund also invests in the two major UAE markets, Abu Dhabi and Dubai, as well as Egypt, Jordan and Morocco.

"We are bottom-up driven; countries and sectors are a secondary consideration," says Mr Krombas. "At the same time, as all the markets are not correlated to each other, for the whole portfolio risk, it is beneficial to us if we can find good companies in different markets," states Mr Krombas.

LIMITATIONS ON FOREIGN OWNERSHIP

Rules of foreign ownership limitation, which set the percentage of shares that can be held by foreign investors in companies are still prevalent in the region and clearly narrow the universe of companies foreigners can invest in.

"Once the stocks have been screened to foreign ownership and liquidity, we come down to 250 eligible investments," says Mr Krombas. That number includes only three sector biased investments in Saudi Arabia, which is the largest and most liquid market.

In Saudi Arabia, in fact, foreign investors can only invest through mutual funds but are not allowed to invest in individual stocks. However Mr Krombas expects that this will change in the next 6 months, in view of the possibility of accessing the country through P-Notes (Participatory Notes) or structured products offered by Saudi banks. "That should increase our investable universe significantly from 260 to 340," says Mr Krombas.

Mr Krombas says he has recently decreased the fund's

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assets invested in Saudi Arabia funds from 10 to 5 per cent as the outlook is currently better for other countries and stocks.

In the SG fund, the top 10 stocks of the 40 total stocks represent 40 per cent of the portfolio, which is strongly biased towards domestic stocks. "The economy backdrop of high oil prices and the infrastructure spend means there is a very good outlook for these stocks, that's where we are seeing earnings visibility and that's where we feel the prospect is better."

One of the key arguments for a specific asset class - against those funds investing in the broader region - is a higher uncorrelation to traditional markets.

"GCC countries are the part of the world which arguably would be immune to US slowdown," says Mr Krombas. "If you start including Israel and Turkey, you are already increasing links to more Western markets; plus they are already in global emerging markets indices so they are much more subject to the whims of global fund flows."

Correlation could increase over time as foreign ownership is increasing, particularly in Dubai and Abu Dhabi, but in Kuwait, Saudi or even Qatar it is still very low, he says. Although the product has attracted some criticism from investors who would like to include Africa as well as the Middle East, says Mr Krombas, in large feedback has been positive.

Domestic fund managers claim to have the relative advantage of being able to access all Arabic markets

including Saudi Arabia. One of the biggest and best known funds of this kind is the traditional and long only regional MEDA (Middle East and Developing Africa) fund, domiciled in Bermuda, offered by leading EFG-Hermes investment bank, which operates from its offices in the Middle East and North Africa region. The fund, which has just under $1bn of assets, delivered over 50 per cent return in US dollars last year and since its launch in 1999 it produced an average return of 20-25 per cent, states Hashem Montasser, global head of asset management at the firm.

The company which is listed both on the Cairo and Alexandria Stock Exchange as well as the London Stock Exchange, manages around $7bn of assets in equity and fixed income funds. "The fund has a very bottom up approach and a very large coverage on the buy side, compared to many of our competitors and for the past four years we have been able to outperform our competition," says Mr Montasser.

The fund owns between 35 and 45 companies, selected from a universe of 150-160 companies. Banks in Europe can create a Luxembourg based access note on the offshore funds and offer it to investors this way.

"Some of the banks set up their own structure which aggregates all the investors and orders in the fund. We also have a number of notes that we set up in collaboration with international banks, such as Barclays Capital and Credit Suisse, targeting retail and high net worth European investors," says Mr Montasser.

EFG-Hermes is also launching a Saudi Arabia equity fund in the near future. "We recognise that many investors want pure Saudi Arabian exposure and cannot do invest directly. There is a large opportunity in the Saudi market, which is the largest emerging market in the world, after China, in terms of liquidity and market cap," says Mr Montasser.

Other major fund houses are currently assessing the possibility of launching a Middle East fund but in the meanwhile have offered access products.

Last December, DWS launched a managed certificate, primarily focussed on the GCC countries, excluding Saudi Arabia, plus Jordan. The product, which is semi-actively managed, aims to meet growing client demand and has gathered $18m in the first couple of months.

"We wanted the play the pure Middle East story and give quick access products to our investors in short lead times," says Jens Schleuniger, fund manager equities EMEA at DWS Investment. He says the firm has been analysing the region for 18 months. Last year, DWS also launched a new frontiers fund, with 40 per cent exposure to the Middle East.

BROAD EXPOSURE PREFERRED

Other major fund management firms have chosen exclusively the emerging EMEA route and support it strongly. One of these is Fidelity international which has launched an emerging EMEA fund managed by Nick Price, in its Luxembourg Sicav last June.

Over half the €1bn gathered by the fund so far has been sourced from retail distribution and the other half from wholesale distribution, explains Michael Jones, head of financial institutions at the firm.

"The fund has really caught the imagination of the retail investors," says Mr Jones. But feedback from wealth management community has been they would chose to buy a pure Eastern European fund and a pure Africa fund and not combine the two regions. "We don't think it is the right approach in fact."

Middle East and Africa and Eastern Europe including Russia are effectively developing markets, and the region contains the majority of the world oil and aluminium reserves and a number of commodities, benefiting from the growth in India and China. Exposure to Middle East itself is relatively small, about 10-15 per cent, as the fund is dominated by market capitalisation by Russia and South Africa. However, the exposure to Russia and South Africa is capped and no holdings can be more than 5 per cent of the fund. This ensures that the fund is not skewed by the weighting of the big companies in South Africa and Russia, says Mr Jones.

"Also, we take the view that you don't have to invest just in the Middle Eastern countries to benefit from the growth in the Middle East." Companies that are doing construction in the Middle East also can be included, so that investors can gain access to the region from companies that are listed elsewhere.

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"It is a higher risk fund, there is no doubt as it is a developing market type holding. But we feel comfortable because it is broadly diversified, it is not just a ME fund, or Russia, or Africa fund, it bring all those assets together, so the effects of diversification is to reduce the overall risk profile of the fund."

Since its official launch in June 2007, the fund has returned 15 per cent, outperforming its MSCI Emerging market index which returned 6 per cent, says Mr Jones.

ASSESSING THE REGION

Strategists at wealth management firms and private banks are expressing interest in the Middle East but most seem to be still at an explorative stage at the moment. While Merrill Lynch private bank is cautious on emerging markets in general, it has pretty upbeat views on the Middle-Eastern market, as Gary Dugan, chief investment officer at Merrill Lynch Global Wealth Management in EMEA puts it. "You can't invest a huge amount of money in the Middle Eastern markets because they are generally quite illiquid, but it is area that we are still buyers of, even in the crisis. This is something we put new emphasis recently."

Pim Mol, member of the global management board at Fortis Private banking, says that the Middle East theme will be offered to clients later in the year and at the moment they are researching a number of funds over there. "We are looking at funds like the EFG-Hermes Meda Fund or the Arab gateway fund, because these are amongst the largest funds." With these offshore funds, they will probably do a kind of structure, providing a multi-manager Middle-Eastern fund, says Mr Mol. "We are get more and more inquiries from our private clients about the Middle East. This will become quite a topic in the next couple of years," he says.

Fredrik Nerbrand, head of global strategy group private banking at HSBC Private Bank UK, says that they have been "keen advocates for the Middle Eastern markets over the last five or six months. The only problem is that it is quite difficult to get access to," he says.

HSBC Investments launched a new frontiers fund earlier this year, and Middle Eastern market represents the largest of the new frontiers markets. "We are getting some exposure through there, as direct exposure is rather difficult," says Mr Nerbrand.

Other major private banks, such as Commerzbank, have not registered enough demand from clients to encourage them to analyse the area.

Thomas Tilse, head of portfolio strategy for private clients, at Commerzbank's asset management arm Cominvest, says that Middle East and North Africa are not on their asset allocation screen, for the moment. "We are much more focussed on emerging markets, including Southern America, Eastern Europe, Asia and we simply have not looked at the Middle East. We have no expertise in assessing the Middle East. If there was some passive exposure, I would probably consider it," he says.

MANAGING VOLATILITY

They may be less correlated than the global emerging funds to the traditional markets, but Middle East funds too have a high degree of volatility, which investors must be made aware of. "There are two ways to approach volatility within emerging markets," says Claire Simmonds at JPMorgan Asset Management. "One is to take a long term investment view of 3 to 5 years and use volatility as a buying opportunity. The second is to take a short term or tactical view and try and take advantage of volatility. In our Middle East equity fund we try and do the former."

Volatility is an inherent part of investing in the emerging markets, but the long term investment approach allows you to tap into that structural upward path, says Ms Simmonds

"In the Middle East clearly the risks lie both at the global level with regards to the global backdrop and investor sentiment; also politics dominate in the Middle East as one of the risk factors," she says. "The other great challenge for the region is to establish the sustainability of the current economic boom ensuring that their energy endowment is a blessing and not a curse." That means ultimately reducing the reliance on energy and there are already initiatives in the Gulf to diversify the economy away from energy and create broader trade integration, says Ms Simmonds.

Mr Krombas at Société Générale Asset Management estimates that the main risks are country specific risks. "All of these different countries tend to have either very influential royal family leaders or political leaders and they are aging. So there are uncertainties there and in many cases there are no clear succession policies. The major risk, rather than being some big geopolitical risk is more country specific. You've got to manage that risk," he says. He is also keen to emphasise that the oil price is very important to the region but in the actual equity market, oil and gas only represent only per cent of the markets.

"All the state companies, which run the oil and gas for the region, are not listed. Many people think [investing in the region] is a play on the oil price. But in actual fact it is not - at least not on the short term movements in the oil price." Any drop or increase in price would not make a difference to the investment case "because the infrastructure spend, which is driving the domestic economies, looks fairly well set to today's levels," adds Mr Krombas.