Funds@Work®

THE INVESTMENT INDUSTRY'S STRATEGY CONSULTANT

The Best of all Worlds –
Towards a more Sustainable Financial System

Islamic finance currently plays a minor role compared to conventional and ESG (Environmental Social Governance) based investments. Its principles though have the potential to form the fundament of a global financial system that is relying less on debt/leverage and is closer to real economic activity, ensuring that economic transactions are underpinned by real assets, and that profit and loss sharing is the norm.

The financial world needs to 'connect the dots' in network analytic terms and build on the best of all worlds from conventional, ESG and Islamic finance investments to make the system more sustainable, stable and resilient. The mainstream conventional system has too long depended on easy money, high debt levels, and developed a detachment from real economic activity and there is a clear call for change.

Islamic Finance on the other hand has to become more socially responsible and apply ESG and other non-financial criteria in its investments. Islamic investors should not only care for Zakat (i.e. the distribution to the needy) but ensure that environmental, social and governance criteria are considered as well. Here both the conventional as well as Islamic investors can greatly learn from those that apply ESG criteria and who increasingly act as "active shareholders", engage with the companies they invest into and take care of their fiduciary duties. This is particularly important in our modern capital markets where the people owning the companies are generally detached from the ones who manage them, creating a corporate governance vacuum that needs to be more strongly addressed. We all know the moral hazards that can arise from principal agent related issues but still today the level of control and incentives (sticks and carrots) in order to align interests between principals and agents is very different among conventional, Islamic and ESG investors with the latter being most advanced and seeing themselves as active shareholders and not just investors in "financial instruments" which carry an ISIN number.

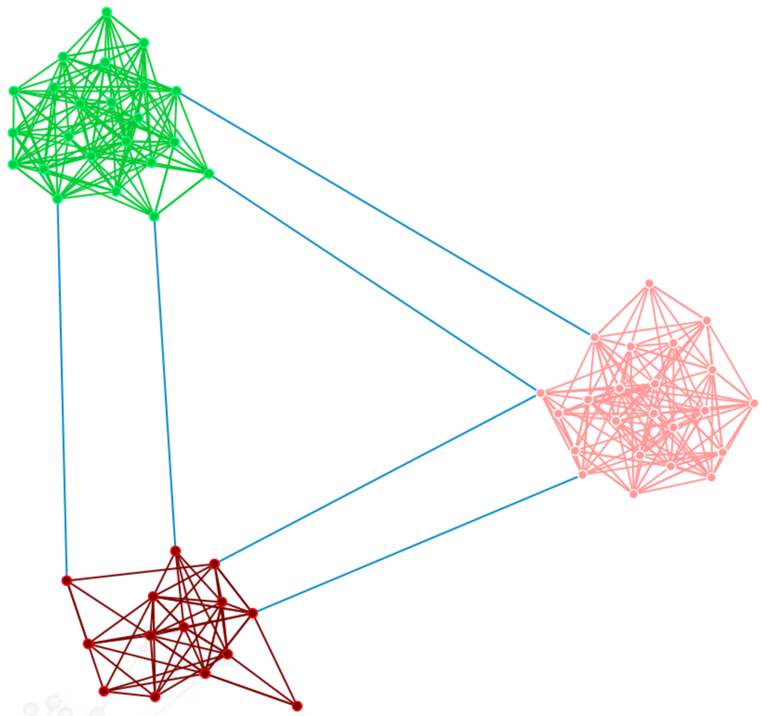
ESG investors e.g. exclude companies that don't meet their ESG criteria, as do those in Islamic finance. But the latter should also develop a tool set to include "non-financial factors" in their decisions as investors do when they consider environmental, social and governance (ESG) criteria, and engage with companies as well as vote based on their shares.

A focus on ESG factors only however, as we argue, would not have prevented the current financial crisis as it is predominantly based on financial factors such as the level of debt, leverage, and mere speculation/short-termism of market participants with a major detachment from real economic activity. Of course, algorithmic trading but also basket trades on behalf of exchange traded funds add to the declined holding periods. Therefore, our vision of the financial services industry is one which connects the dots between the conventional investment industry, ESG related investments, and Islamic finance. A system where investors use "Islamic principles" and start incorporating ESG factors on top of Zakat (where part of the income is distributed to the people in need) which can help create a more equitable system with greater transparency. To get there, conventional, ESG and Islamic finance should learn more from each other and combine the best of all worlds when it comes to using financial and non-financial factors.

The Status Quo

We know from network theory that the openness of groups to outsiders` views is a crucial element in being more innovative, so diversity pays off. The following simplified graph shows us the three groups, namely Islamic Finance (red), ESG (green), and conventional investors (light red) which are communicating more densely within their groups but less so between the individual disciplines. There are a few boundary spanners that connect the individual groups but that is certainly not enough. This can even be seen in major conferences which are either dedicated to "conventional", "ESG" or Islamic Finance" topics but don`t provide an equal platform for all disciplines to engage in dialogues and learn more from each other. The mere communication with people that are alike does not help to move knowledge beyond individual networks which on the other hand could greatly profit from new perspectives. So in order to advance mutual learning, people from the individual disciplines should look beyond their own borders, something though that is hardly being done. There is certainly more learning going on when we talk about the value added of Islamic Finance principles to ESG and conventional investors and ESG investors highlighting their tool sets to the other two disciplines. The lack of interaction, as usual, creates prejudices and leads to less sophistication for all. We should not argue about which system is more powerful than the others but look for common denominators which make all disciplines stronger. The middle of the road approach has always proven to be more successful.

A simplified network graph of "current" interaction between Islamic Finance, ESG, and conventional investors



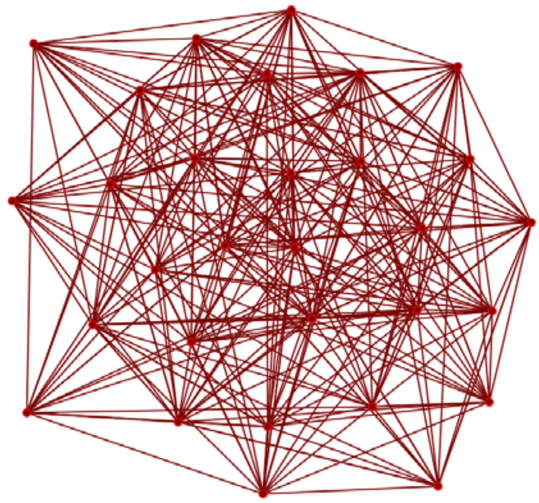
Source: Funds@Work AG

The desired state

In the future a greater convergence and interaction among the three disciplines would be more desirable with the relevant groups being less distinguishable leading to a more "Sustainable Finance" industry. Islamic, conventional and ESG investors should be more open to each other enter into a mutual dialogue and transfer learning for the sake of a more resilient and sustainable financial system. As the following graph shows we should no longer be able to distinguish the individual players and don`t create subgroups which are detached and act in an almost isolated fashion.

In such an environment the label "Islamic" or "ESG" will be less important as it is the value added that each discipline brings on the table from which all can profit leading to a more sustainable finance industry where the individual disciplines borrow greatly from each other.

A simplified network graph of a desired "future" interaction between Islamic Finance, ESG, and conventional investors



Source: Funds@Work AG

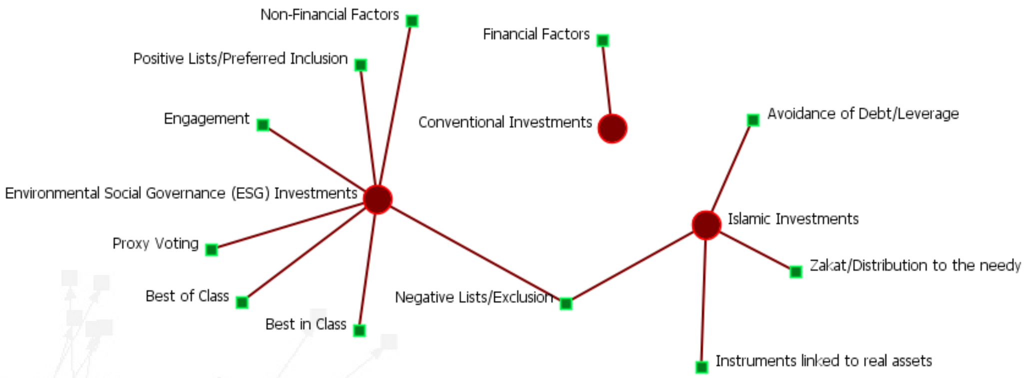
The Best of all worlds

In the following network graph we would like to focus on the distinctive approaches (green squares) which the individual disciplines, specifically Islamic and ESG Investors apply.

Here we treat conventional investments as an isolate that builds predominantly on financial factors in the investment decision making process. As you can see there is an actual link between Islamic and ESG investors namely the usage of negative lists where sectors or companies belonging to a certain sector are clearly excluded. This applies to companies e.g. in the weapons, gambling, tobacco and other industries which both disciplines would exclude in their investments. Whereas ESG investors focus mainly on non-financial factors when it comes to environmental, social, and governance standards, Islamic Finance's focus is more on financial criteria and specifically the avoidance of debt/leverage. The emphasis on transactions that are backed by real assets making them closer to real economic activity are certainly also a cornerstone. An important element is also Zakat, the distribution to the needy based on a specific percentage of the profits made.

ESG investors` interest is particularly in non-financial factors and apart from acting as an active shareholder by voting at annual general meetings of companies they are invested in, they engage actively with companies to minimize risks but also enhance value in the long term. Furthermore they apply positive lists to consider sectors that are particularly worthwhile investing into or determine which companies are best in their class in terms of ESG standards, such as in the automotive sector, to invest with those or just the single company which is best of class in a given area. The tool sets developed by sustainable investors are more varied and lend themselves well for conventional and Islamic investors alike.

A simplified network graph of the "current" major approaches Islamic Finance, ESG, and conventional investors apply



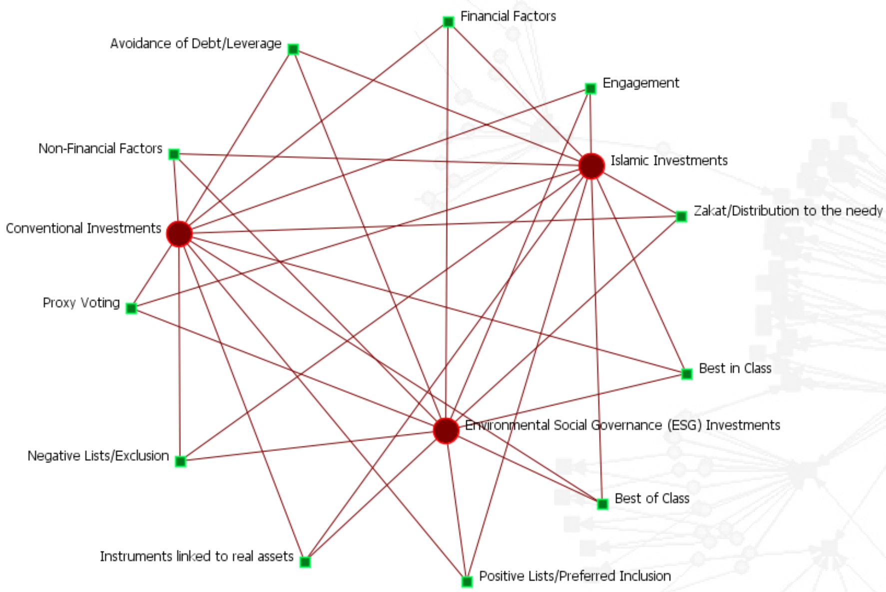
Source: Funds@Work AG

Our vision of a sustainable investment industry

The individual approaches and the wealth of knowledge that the conventional investment industry created need to converge more strongly to contribute to a more resilient, stable, and sustainable financial system. In the following graph we highlight what this system should look like where all the individual disciplines borrow from each other to provide a more sustainable environment. When it comes to exclusion of companies e.g. even conventional players should exclude weapon manufacturers as we all know the negative impact the industry has on our lives. Conventional, Islamic and ESG investors should become active shareholders and address the vacuum which has been created by modern capital markets. Engaging with the companies in which they invest, voicing concerns at annual general meetings and entering into a dialogue with the companies invested into should be the norm. We should move away from short-termism by not looking at companies whose equities and bonds we hold as mere financial instruments but see ourselves as shareholders and fiduciaries. If ESG and conventional investors address the issue of leverage and debt more strongly, ensure that transactions are no longer naked but asset based and linked to real economic activity we can transition into an era where equity is on the agenda again and the focus is on profit and loss sharing rather than central counterparts who provide guarantees and become too big to fail.

Islamic Finance investors should borrow from ESG and develop positive lists for sectors that are worthwhile to invest into. This could be a way to prioritize areas such as microfinance, alternative energy, health, education and other relevant sectors which are necessary for the societies in which they operate. And of course why shouldn`t the concept of Zakat be one applied by all three industries where we give back to society. Islamic Finance is not just a religious concept but should be rather seen from the perspective of the contribution it makes to a more resilient financial system, therefore we need to educate ESG as well as conventional investors about its virtues. It cuts though both ways as Islamic Finance can learn greatly from ESG investors, develop more sophisticated approaches in investing and at the same time move away from its focus on financial factors to become more socially responsible.

A simplified network graph of the "future" major approaches Islamic Finance, ESG, and conventional investors should apply



Source: Funds@Work AG

Summary

Our aim was to show that we should never look at phenomena in an isolated manner. Islamic, ESG as well as conventional investors can greatly learn from each other by being more open. Islamic Finance should not be looked at from a religious perspective but rather from what it brings to the table from which ESG and conventional investors can profit. Our finance and investment system globally will be more resilient if individual participants approach each other more openly and share ideas converging into a mainstream "sustainable finance system" which borrows the best of all worlds.

From a network analytic perspective we should be aware that openness leads to greater innovation and stability and creates more opportunities to interact. In this context we need to address prejudices which stem from mere ignorance and act as barriers to cooperate. Because ultimately what the world needs is a greater integration of networks such as the Islamic Finance, ESG, and conventional investments communities to make their individual achievements accessible to a broader audience. What we don`t need are sectors that act in isolation and pride themselves to be superior vis-a-vis the other disciplines. Ultimately each of us and any organization that we represent is embedded into a wider social ecosystem, if we start actively learning from and talking to each other we can bring about greater stability for the sake of all.

Celebrating 11 years of pioneering work and innovative research with more than 200 projects across Europe and the Gulf

We are a research based strategy consultant focusing on the investment industry. We assist local and international clients in developing new solutions and organizations and have been involved in numerous market entry as well as expansion projects, reducing time to market greatly, helping our clients intensively in implementing their holistic strategies. Among our customers are mainly asset management companies, portfolio managers, stock exchanges, and other relevant entities of the asset management industry´s value chain.Our clients are those that offer investment products, solutions and platforms for asset owners but also provide the regulatory framework for the industry.

As part of our unparalleled market intelligence we cover among others over 14,000 asset owners, i.e. those that use the products and services of our clients. Here we apply a daily model-based screening process as well as (social) network analysis and visualization, in order to gain deep insights into market participants` needs, motivations and relationships, thus giving us a 360 degree perspective. We use this deep and unparalleled knowledge about our clients´ customers to develop targeted strategies and carry them out in a holistic manner, building on unique data and methodologies rather than "gut feeling".

We have won over a dozen of international and presidential awards for our unique research which is the basis for our successful consulting practice and have pioneered in many ways. We are well known globally e.g. for our systematic application of social/organizational network analysis and visualization to shed transparency into the 1) conventional, 2) socially responsible (ESG) as well as 3) Islamic finance industry. Our complementary focus on the three relevant sub-sectors is indeed unique and helps us to better grasp the changes in the asset management industry as a whole internationally.

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