



GCC ASSET SERVICING ROUNDTABLE

Helped by a strong recovery in oil prices and attendant higher levels of government spending, the Gulf Cooperation Council (GCC) countries are witnessing a return to robust growth. The IMF estimates real GDP growth of 5.9% is achievable in 2011, and at current levels of oil production (around 14.7m barrels/day), and based on an average price per barrel of \$83 (which was the average last year), GCC countries generate at least \$1.2bn in oil revenues alone, each day. While this is still short of the average \$2bn per day in 2007, it is sufficient to provide oil generating economies with a substantial current account surplus. Despite some political instability which has marred the overall 2011 outlook for some GCC countries, the region looks set to continue to nurture growth, sustained by population growth, a growing labour force and rising savings. Moreover, reform efforts have been moving ahead across the region. Kuwait's privatisation programme and continuing market reforms in Qatar, UAE and Oman will likely spur further investment inflows and provide opportunities for local investment firms to leverage the region's growth. With this backdrop in mind, we have invited comment from some of the region's experts in asset management and asset servicing to provide us with their insights into the continuing reforms, opportunities and challenges for their particular business segment. We hope you find the discussion stimulating.

ASSET SERVICING IN A HIGH-GROWTH REGION: THE RISKS & REWARDS

Photograph © © Madmaxer / Dreamstime.com, supplied June 2011.

Participants

MOHAMMED AL HASHIMI, executive director of asset management, Invest AD

JONATHAN COOPER, managing director, Middle East & Africa, FTSE Group

ALAN DURRANT, group chief investment officer and general manager, asset management group, National Bank of Abu Dhabi

BRIAN LEDDY, head of relationship management, EMEA, BNY Mellon Asset Servicing

Supported by:



BNY MELLON
ASSET SERVICING



GCC ROUNDTABLE

THE STATE OF PLAY IN THE GCC

FTSE GM: Local investment management is dominated by the region's banks. Is a strong independent GCC fund management industry likely or will they be squeezed by the banks on one side and the international players on the other?

ALAN DURRANT, GROUP CHIEF INVESTMENT OFFICER AND GENERAL MANAGER, ASSET MANAGEMENT GROUP, NATIONAL BANK OF ABU DHABI: The GCC is probably over supplied with financial services in general. In most countries there are too many banks, too many brokers and yes, too many asset managers. In asset management however, there is always room for truly great performance. If an asset manager can build a strong enough track record, they are likely to be rewarded with a robust business. However, for every one business in this position, there are ten with poor records, excessive cost bases, tiny funds and it is hard to see how they can compete or even survive going forward.

JONATHAN COOPER, MANAGING DIRECTOR, MIDDLE EAST & AFRICA, FTSE GROUP: Perhaps the issue is less about who dominates the industry but who actually generates the investment mandates. The GCC is home to some of the world's largest sovereign wealth funds but lacks the depth of asset owners who could help stimulate the industry.

BRIAN LEDDY, HEAD OF RELATIONSHIP MANAGEMENT, EMEA, BNY MELLON ASSET SERVICING: If we look at mature markets in Europe or North America, it is clear that size and success are not necessarily synonymous. Investment management houses at all points on the scale continue to thrive by delivering outperformance to their clients. The independent fund managers of the GCC may face the same challenges as their peers elsewhere in the world, particularly with distribution channels which obviously favour the local banks with their extensive branch networks. Even so, sophisticated investors will seek out the manager whose philosophy best meets their requirements. The local players may experience some squeeze, but the fittest will survive.

FTSE GM: What are the benefits/limitations of having private banks as the primary source of distribution in the region?

ALAN DURRANT: Private banks can form excellent long-term partnerships for investment banks. Private bankers form decades-long relationships with their clients; relationships that can move from one employer to another. A good private banker is not just a product-pusher, they are long-term partners for the clients and therefore they will need to be thoroughly convinced that the product they are taking to their client bank is a robust one. This will usually elongate the time it takes for products to be adopted and this wait can be frustrating. However, the strength of the long-term relationship is most certainly worthwhile and this is why we devote so much time to private banks.

FTSE GM: How can local firms compete in the investment management and asset servicing space?

MOHAMMED AL HASHIMI, EXECUTIVE DIRECTOR OF ASSET MANAGEMENT, INVEST AD: We compete by demonstrating that our physical presence in the Middle East aids our investment decisions. Having access to nearby economies, or countries gives local firms the ability to be able to visit management teams of the companies that they are investing in. Most importantly, we believe that having analysts on the ground in local markets is critical and the most effective way of truly valuing companies and making the best returns for investors.

FTSE GM: As the GCC continues to integrate, how important is it to be able to offer a pan-regional presence?

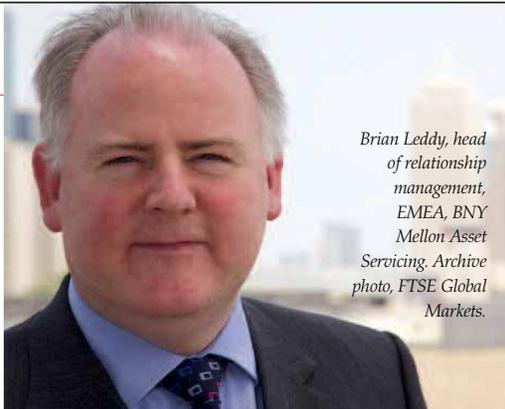
MOHAMMED AL HASHIMI: The GCC markets are relatively smaller than Latin America or the Far East. Europe is different from the GCC because of its currency integration. Having a pan-regional presence is important in the GCC because each market still offers unique investment attributes. Each market in the GCC still offers unique investment attributes. For example, in Saudi Arabia you can invest in sectors unique to the country, such as petrochemicals or retail stocks. To invest in ports, you go to DP World in Dubai. Looking outside of the GCC, having an integrated pan-MENA offering is also very important, especially when it comes to investing in Africa as the countries tend to vary so much.

BRIAN LEDDY: I would suggest that it is more important to offer a pan-regional capability than presence. The key issue is to ensure that you can deliver your products and services to your target clients in each of the GCC's markets but, as your question points out, the GCC continues to integrate. This integration has the benefit of allowing us to take a service domiciled in one market and offer it into one or more of the others. This "passporting" philosophy may currently be imperfect but it does allow service providers to deliver their products across the region without replicating offices and functions across each and every country.

ALAN DURRANT: We believe that it is very important. National Bank of Abu Dhabi has had a strong roll-out programme in place for many years and this will continue. Busy investors do not want to have a dozen small providers each serving a part of their wealth. Instead they want a few holistic financial service providers who can serve a wide range of their needs wherever they happen to be.

FTSE GM: How can white labelling work in practice for local firms that want to offer the widest possible product offering to their clients?

ALAN DURRANT: It all comes down to distribution. If you have a trusted brand name and strong distribution channels, there is every reason to believe that you can offer good quality, white-labelled product. If you lack distribution, what are you really bringing to the manufacturer by white labelling?



Brian Leddy, head of relationship management, EMEA, BNY Mellon Asset Servicing. Archive photo, FTSE Global Markets.

FTSE GM: What are the key markets for investors in the region outside of the GCC?

BRIAN LEDDY: The market that immediately springs to mind is Egypt. Its market capitalisation is broadly comparable to those of the GCC markets and it is a mature market with a well established regulatory environment. That being said, a number of other markets are deserving of scrutiny from investors seeking exposure to the region. Morocco continues to present interesting opportunities and the Levant is not to be ignored.

ALAN DURRANT: They are a blend of the markets and countries that they know well and feel comfortable in such as the UK and Europe with exciting markets that are likely to provide the next wave of growth such as China and India.

FTSE GM: What is the portion of Shari'a-compliant funds and products?

ALAN DURRANT: Most surveys suggest around 30% of the investor base favour Shari'a-compliant product. This will vary depending upon the expat versus local mix of clients. However, we take the view that good Shari'a product should be capable of being bought by all client types.

FTSE GM: Is there always a case where bigger is always better or does local knowledge and expertise offer something different from the global firms?

JONATHAN COOPER: Well of course you have scale as a global firm but local knowledge and understanding the culture is very important in this region.

MOHAMMED AL HASHIMI: From a regional standpoint, it is not always necessarily the case that bigger is always better. Nowadays, investors have become a lot more demanding about quality. There is much more appreciation for local presence and expertise which can offer meaningful insight such as research and coverage of companies in a specific region. There is a lot more room for boutique or local firms to grow that can offer detailed understanding of emerging markets.

ALAN DURRANT: We have little doubt that local specialists can have the edge over global firms, but you must know which areas you will choose to specialise in. We acknowledge that we will probably never be best-of-breed in Japanese small caps or Latin American debt and therefore we don't try.

We have chosen to outsource this. In contrast, we strongly believe that we are among the best informed people in the world when it comes to local equity, bonds and property and that we can manage these asset classes better than major asset managers based in London, New York or Tokyo with little or no resources devoted to the GCC. This is why we are entering into many reciprocal partnerships in which we will manage GCC products for global house and they in turn will manage assets that are outside of our skill set.

PRODUCTS & INVESTMENT STRATEGIES

FTSE GM: How important is it that large local asset owners continue to increase their exposure to local markets rather than invest solely or primarily overseas?

ALAN DURRANT: Events of the last three years have clearly shown the importance of diversification. Most local stock markets have been both volatile and weak during this period and the experience of many investors into local real estate and private equity has not been a happy one. Of course, it has been perfectly possible to lose money in the US, Europe and even Asia during this period but in general, overseas exposure has been a good counterbalance for the losses made locally. With the US dollar having been weak recently against most major currencies and most GCC currencies having a peg, the performance of non-dollar overseas assets has been even better for GCC based investors.

FTSE GM: How important is it for international asset managers and servicers to have a significant presence on the ground rather than simply a sales operation?

ALAN DURRANT: We are indifferent and so are our clients. We wouldn't offer to go to California to manage GCC equities for US-based clients and see no reason why a US technology fund should be managed from the GCC. So long as the asset management and service are first-class, there is no reason for us to demand that our partners rebase here.

FTSE GM: What are the key markets for investors in the region outside of GCC?

MOHAMMED AL HASHIMI: The key markets outside of GCC would be Egypt and Morocco for North Africa, and Nigeria and Kenya for sub-Saharan Africa, as they are the biggest economies.

JONATHAN COOPER: North Africa has often been a focus for investors. Earlier this year FTSE launched an initiative with the Casablanca Stock Exchange to create a series of domestic indices. Despite some of the challenges facing North Africa the FTSE CSE Morocco 15 Index has performed in excess of 10% year to date.

FTSE GM: How common are hybrid funds that allow investments in equities, pre-IPO and private firms? Are ▶▶



GCC ROUNDTABLE

these more suited to the region than traditional long only equity funds?

MOHAMMED AL HASHIMI: Similar to fashion, investments go through trends as well. Hybrid funds are not as “trendy” now as they were in the 1970s. In our region, single-type equity funds are still prevalent. Although a combination of funds is feasible, there are a number of challenges in our region which makes hybrid funds less convenient and popular. There is still very limited demand for combination exposures. Liquidity is paramount when managing a public equity portfolio in an emerging market. Pre-IPO and private equity is slightly different as it is harder for investors to make redemptions. The preference now is to separate listed equities and private equity, unless there is a particular mandate for a specific client who chooses a hybrid fund. If this is the case, it is more manageable since it is a closed mandate.

JONATHAN COOPER: As an index provider this might be a difficult combination to achieve. Some IPOs and primary listings have free float restrictions which would impede upon international investors.

FTSE GM: What has been the take up of new products such as ETFs?

JONATHAN COOPER: This is certainly an area where the GCC is lagging as there are some issues around access to data. ETFs provide easy and transparent exposure for investors at minimal cost. ETFs could help boost interest in local markets and increase volumes in the underlying stocks.

ALAN DURRANT: It has been slow but we have little doubt that they will be adopted in the GCC just as they have come to dominate the international markets. I think that the weakness of local equity markets has been a significant contributory factor in the slow start but with signs of life returning to local markets, we expect renewed interest.

LOCAL REGULATIONS & MARKET STRUCTURES

FTSE GM: The region’s stock markets are dominated by retail investors. How can these investors be educated away from direct investments and towards investment products?

ALAN DURRANT: This is the major challenge facing asset managers. We are actually competing with many potential clients who believe that they have better insight than a fund manager. The volatility of the last few years will have pushed a few towards professional fund management but I suspect many will simply have left stock markets altogether.

MOHAMMED AL HASHIMI: Educating investors is an ongoing process driven by regulators and by participants themselves, *ie*, analysts, asset managers and client relationship managers. In general, it is much more efficient to have professionals managing your money. However, the process of educating investors is ongoing and will take many years to work through.



Alan Durrant, group chief investment officer and general manager, asset management group, National Bank of Abu Dhabi. Archive photo, FTSE Global Markets.

FTSE GM: How does regulation compare across the region, what improvements could be made?

BRIAN LEDDY: There are significant differences in the regulatory environment across the different markets of the GCC, but we should bear in mind that these regulations are supporting some very different market mechanisms in trading, clearing and settlement. While these differing market mechanisms will not represent a barrier to a local investor trading in his home market, we should acknowledge that consolidation, or at the very least homogenisation of the GCC’s markets towards a transparent, low-risk model would make them considerably more attractive to foreign institutional investors.

JONATHAN COOPER: Although there are some major differences, regulators across the region are making improvements and trying to adopt best practice and international standards. FTSE was the first index provider to announce that the UAE is classified as an emerging market in the FTSE Global Equity Index Series and that Kuwait remains on a watch list for inclusion. Improvements in foreign ownership restrictions and free float would be welcomed by institutional investors.

MOHAMMED AL HASHIMI: Regulations differ widely across the region. It is important to understand that regulations evolved at different times within the region. In the UAE, for example, regulations evolved in the early part of the 21st century, whereas in Kuwait it took place in the Eighties. The key difference between countries in the GCC is the level of access that foreign investors can have in listed companies. In Saudi, for example, foreigners can participate through Saudi-focused funds or through swap arrangements. There are a number of improvements to be made, such as providing wider foreign participation, more transparency, and improvements in settlement mechanisms such as a delivery versus payment (DVP) system. Regulatory improvements in more advanced emerging markets such as the BRIC economies should be observed and adapted in the region.

FTSE GM: How likely is regulation that encourages the use of external providers for asset servicing in order to decrease operational risk?

BRIAN LEDDY: The segregation of duties is a universal theme in regulation, and one that is already being taken up within the GCC. The fundamental requirement is that the



investment decision maker should not be the same entity who reports the results of that investment decision. Accounting, valuation and performance reporting must all be independent of the management function. These products in general sit along side the custody processes of settlement and safekeeping. So by definition, the regulations being considered or enacted recognise the value of an external provider of asset servicing distinct from the asset manager.

ALAN DURRANT: I believe it is increasingly likely. I would disagree that this in any way decreases operational risk. This all comes down to the quality of the people, processes and systems of the back office. If good internal people, processes and systems are in place, then the risk of operational problems could even be reduced as everything is under the control of one entity. If service standards slip, it is easier for them to be addressed. However, for weak businesses that cannot afford to invest in the best people, processes and systems, then outsourcing is probably the best option.

FTSE GM: Are UCITS-compliant funds becoming the *de facto* benchmark in terms of structure?

ALAN DURRANT: Not yet. I think that they should be and in the absence of any GCC-wide equivalent, I believe that they will be over time.

JONATHAN COOPER: This seems to be the case for local funds seeking foreign institutional investors who are familiar with the UCITS framework.

BRIAN LEDDY: UCITS is specifically designed to deliver a best practice solution to investors in funds. Its intention is to deliver clarity, transparency and investor protection—goals which are undoubtedly shared by regulators across the region. With UCITS already defined and readily available, is there really a need to re-invent the wheel? It is safe to say that UCITS is becoming the standard structure for funds, not least because UCITS compliance is the basic requirement to be able to access European domiciled investors.

FTSE GM: What is the likelihood of an equivalent GCC investment passport in the similar vein to UCITS?

ALAN DURRANT: Very unlikely in my view. A UCITS-like scheme would require massive levels of cooperation between the various regulatory bodies. Currently I see local regulators designing local rules that fit the particulars of their respective local economies and markets.

SERVICING THE ASSETS

FTSE GM: What are the prospects for transition managers in the region?

BRIAN LEDDY: Some of the larger institutions are already using transition management and it is a growth market with a growing number and range of organisations recognising the risk reduction potential that a transition manager



Mohammed Al Hashimi, executive director of asset management, Invest AD. Photograph kindly supplied by Invest AD, June 2011.

can provide. Mature funds require a transition manager when switching asset managers or changing the fund asset allocation. However, there is also demand for transition managers to manage the funding of new portfolios and, in particular, to control the risk when allocating from cash to other asset classes.

FTSE GM: How important to international investors is having an external custodian and fund administrator?

MOHAMMED AL HASHIMI: It is very important for international investors to have an external custodian and fund administrator, as it gives comfort to investors that investment returns are being independently calculated and verified and there is professional oversight of the fund's assets. Until recently, it was a lot harder to outsource to a fund administrator and custodian due to the lack of service providers operating in the region. Due to a recent increase in service providers this option has also become more cost efficient for asset managers.

ALAN DURRANT: In the post-Madoff era, fund governance is becoming ever more important. Most really big investors will insist on either a segregated account under their control or will demand a fund that meets international best practice.

FTSE GM: Is there sufficient competition in the asset servicing and custody space?

ALAN DURRANT: We didn't believe so and this is why we launched our own custody service. Indeed, we were the first locally authorised custodian in the UAE and have been very successful in winning new mandates.

FTSE GM: What are the opportunities for locally managed and invested fixed-income funds?

MOHAMMED AL HASHIMI: In the case of fixed-income funds, the opportunity is limited because the number of fixed-income instruments that are tradable is still limited. Most regional fixed-income instruments are typically held to maturity when issued but there is still a lack of depth and liquidity in the market. However, this is likely to change as more corporates, weigh up their options by looking to issue corporate debt or listing their equities, post the global financial crisis.

ALAN DURRANT: This is an area in which we have deployed a lot of our resources as we see great scope for ►►



GCC ROUNDTABLE

growth and want to cement our position as the leading fixed-income manager. Compared with equities, fixed income has hardly been touched by either amateur or professional investors. As the market broadens we expect growing international interest.

FTSE GM: What are the opportunities in the value add space of transition management and securities lending?

BRIAN LEDDY: In the transition space, cash equitisation and interim management are areas where transition managers with portfolio management experience can add value. This is particularly true in this region where cash injections to funds can be significant. The due diligence process to invest new cash can take days or even weeks. Creating the beta exposure for new cash can reduce the tracking error of the fund to the global benchmark, allowing time to complete the investment review and execution.

OUTLOOK

FTSE GM: What are the key opportunities and challenges facing the investment and asset servicing industry in the region over the next three years and beyond?

ALAN DURRANT: The key risk evident today is simply scale. Asset servicing works best as a huge conveyor belt in which vast funds are pushed through a fixed-cost base to drive the cost per unit down to *de minimis*. Currently in the GCC, this cannot be applied to funds. In the West, \$100m is regarded as a very small fund. In the GCC \$100m is regarded as a normal-sized firm. This will make it hard for asset servicers to offer attractive pricing unless they can simultaneously take on large segregated accounts.

FTSE GM: Will the local equity markets ever be deep enough to support a large institutional investor community?

BRIAN LEDDY: A major issue with the local equity markets is that they are not employed as the first port of call for local companies to raise capital. Many large organisations remain family owned without recourse to the capital markets which certainly limits the overall market capitalisation of the local markets. There is something of a chicken and egg situation here as investors will necessarily limit their concentration in a thin equity market, and issuers will be reluctant to float on a market with limited capital. Also, the volatility these markets have witnessed over the past five years has deterred both investors and issuers. Local markets will likely experience expansion as a gradual process, which in itself should encourage confidence in their long-term stability.

ALAN DURRANT: Over time we would hope to see the buffet broaden. Many GCC stock markets are dominated by a few sectors such as banks and real estate. It would be good to see more of the real economy listed-giving people the opportunity to invest in local airlines, industry *etc.*



*Jonathan Cooper,
managing director,
Middle East &
Africa, FTSE Group.
Photograph kindly
supplied by FTSE
Group, June 2011.*

FTSE GM: What will be the impact of the inclusion of some GCC countries into the global benchmarks?

JONATHAN COOPER: As I mentioned earlier the UAE is already included by investors using the FTSE Global Equity Index Series (GEIS). However, inclusion should not be treated as a single “big bang” event. Funds tracking the series are given a period of time to implement the change and new constituents carry a smaller weighting relative to the total market cap of the index. Being included in GEIS is an important first step but markets need to maintain their standards. Negative changes may also occur as with Argentina, which is now classified as a Frontier Market.

MOHAMMED AL HASHIMI: There has been widespread coverage in the news about adding the UAE and Qatar to MSCI Emerging Markets index. The news coverage has been focusing too much on the short-term benefits for these markets. The focus should be more on long-term impact. If the UAE and Qatar are included in the MSCI index, it will have a positive impact on the GCC as it will attract greater proportions of institutional money since they will be opening up to a wider pool of foreign investors. This will be further enhanced by changes to operational mechanics towards payment systems and foreign ownership, which in turn will lead to improved liquidity.

ALAN DURRANT: There is likely to be a short-term sugar rush impact but over time, it will all come down to the underlying profitability of our companies. That is what drives share prices over time. Getting into benchmarks such as MSCI Emerging Markets will bring our companies onto the radar of international investors but (with the exception of index trackers) they will only invest in liquid, well-managed companies that can demonstrate a track record and a clear growth strategy.

FTSE GM: Is conquering the Saudi market key to being successful in the GCC?

JONATHAN COOPER: Saudi Arabia has the largest stock market in the region and contributes 50% of GDP of the GCC. However, direct foreign investment is restricted and there are other areas where increased competition would be beneficial. Saudi Arabia is clearly an important market but some of the challenges facing The Kingdom are different to other members of the GCC. ■