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Alpha Abound

A Study to explore Alpha generation in GCC

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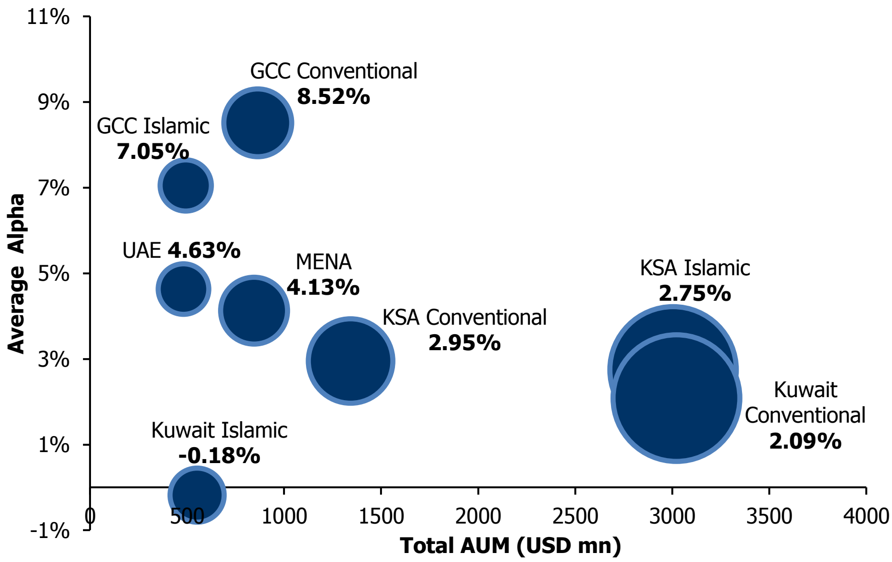
Globally, fund management industry is going through a rough patch after the 2008 financial crisis. As markets exhibit higher volatility and with no easy fixes in sight to solve the problems of the developed world, fund managers are struggling to adapt and clients are increasingly turning restless. The situation in the GCC is no different. Companies continue to struggle in growing their assets under management (AUM) and making ends meet.

As per our study, GCC asset management industry with roughly 100 companies, manage about $26.5bn[1] in assets in 328 funds at the end of 2011. Money market funds constitute the largest share in terms of AUMs (53%), followed by Equities (42%), Fixed income (2%) and specialized funds (3%).

Asset under Management and Average Alpha by Category



Note: Total AUM also includes funds which are not included in the study
Source: Zawya, Reuters Eikon, Markaz Research

In this note, we attempt to provide an insight on the following topics:

1. Are GCC equity funds generating Alpha – Analysed based on Geography, Size, and Type (Conventional & Islamic)
2. If Active managers are generating Alpha, then possible reasons for the same.
3. Can we expect the trend to continue
4. International experience with Alpha generation

[1] Assets under management (AUM) refer only to mutual fund assets unless explicitly mentioned. AUM includes funds with the GCC or one of the constituent markets as their geographic focus

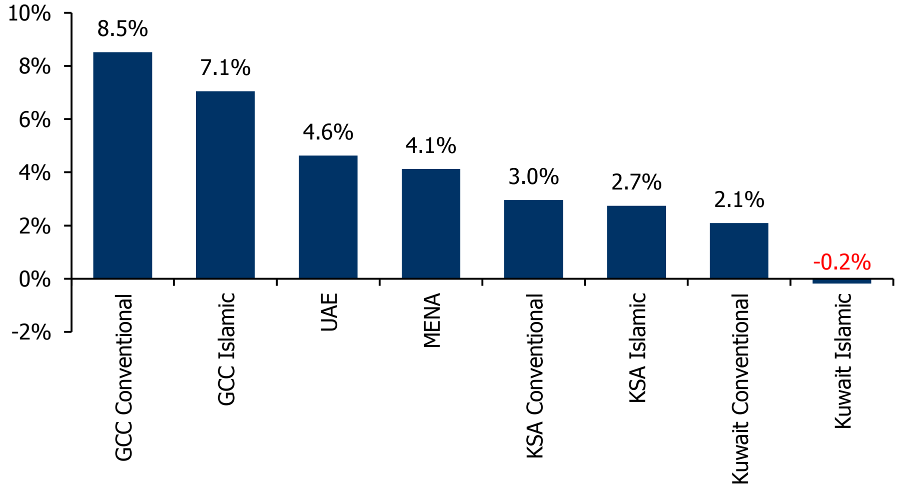
A universe of 68 mutual funds was selected for the analysis

Are GCC equity funds generating Alpha – Analysed based on Geography, Size, and Type (Conventional & Islamic)

We segregated equity funds based on their geographic focus and funds which have Saudi Arabia, Kuwait, UAE, GCC and MENA as geographic focus for investments were included for the analysis. Further, we classified funds as Conventional & Islamic and only funds which were in existence from the year 2006 were taken for the study. So, a universe of 68 mutual funds was selected for the analysis.

The chart below gives a snapshot of Alpha that was generated by funds from each category. On average, funds from almost all the categories generated alpha during the six year period. Kuwait Islamic funds, which generated negative alpha of -0.2%, were the only exception.

Average Alpha by Category (2006 to 2011)

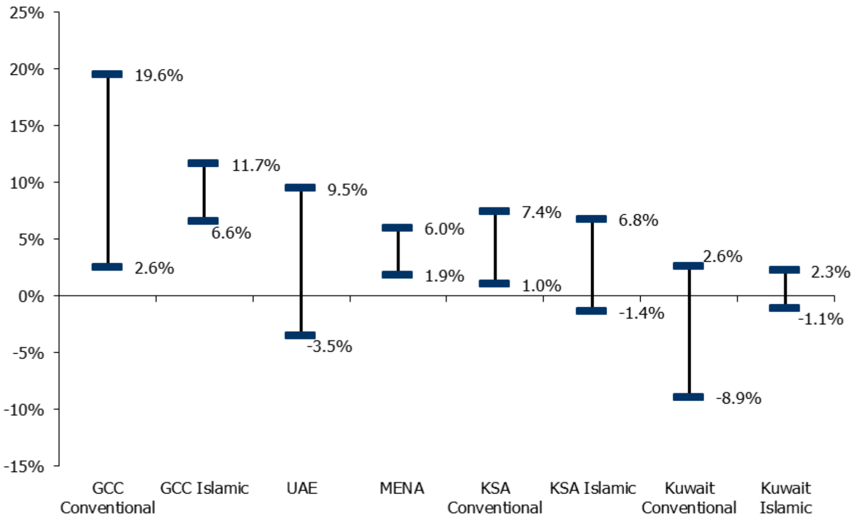


Source: Zawya, Reuters Eikon, Markaz Research

Even though fund categories generated alpha on an average basis, alpha generated by individual funds witnessed a noticeable variation. For example, during the 6 year period, the highest alpha generated by a GCC conventional fund was 19.6% whereas the lowest was only 2.6%.

On average, funds from almost all the categories generated alpha during the six year period.

Range of Alpha Generated by Individual Funds (2006 to 2011)



Source: Zawya, Reuters Eikon, Markaz Research

2009 was tough for fund managers with only one category witnessing more than 50% of the funds outperforming.

The table below shows the percentage of funds that outperformed the index, category-wise from 2006 to 2011. Highlighted cells indicate periods where the percentage outperformance was less than 50%. As it is evident, period following the financial crisis was tough for fund managers with only one category (Conventional Saudi funds) witnessing more than 50% of the funds outperforming. Outperformance was strong in 2008 but dropped significantly in the following two years (2009 & 2010).

Also, the percentage of funds generating alpha is low in Kuwait Conventional funds category. It is lower than 50% in five out of the six years under study. This is probably because of high institutionalization rate in Kuwait. As per our study, the AUM to GDP ratio of Kuwait is 35% if portfolio investments (managed assets) are also taken into account[2]. The ratio is more than double that of the next highest country – Saudi Arabia (15%).

Percentage of Funds Outperforming the Index (2006 – 2011)

Category	2006	2007	2008	2009	2010	2011	Total # of Funds
Market Direction*	**Bear**	**Bull**	**Bear**	**Flat**	**Flat**	**Flat**	
GCC Conventional	100%	18%	100%	0%	18%	100%	11
GCC Islamic	100%	67%	100%	0%	0%	100%	3
UAE	100%	100%	75%	13%	50%	88%	8
MENA	100%	0%	100%	0%	20%	20%	5
KSA Conventional	60%	90%	100%	50%	90%	60%	10
KSA Islamic	36%	73%	100%	45%	91%	82%	11
Kuwait Conventional	27%	40%	60%	27%	7%	47%	15
Kuwait Islamic	100%	80%	100%	0%	0%	100%	5

*Based on S&P GCC Composite returns. Bull Market: Returns >15%, Bear Market: Returns <15%
Source: Zawya, Reuters Eikon, Markaz Research

We also looked at funds in terms their assets under management to see if there is any relationship between fund size and returns. We classified funds into four groups based the following criteria:

Fund Size	Type	Number of Funds
Greater than $500mn	Very Large	6
Between $499mn & $100mn	Large	19
Between $99mn & $10mn	Medium	34
Less than $10mn	Small	9

Source: Zawya, Reuters Eikon, Markaz Research

Alpha generated by individual funds witnessed a noticeable variation

Although we don't have clear results, the Medium sized funds ($99-$10mn) seem to have outperformed other categories in terms of creating alpha. Medium sized funds outperformed in 3 out of the 5 category of funds (Table below). Although the proportion of Very large and Large funds is small, we feel it will be increasingly difficult for such fund managers to beat the index due to lack of market depth across the region. The top heavy nature of the market coupled with low public holding in some of the stocks makes it difficult for large fund managers to find opportunities to deploy money.

[2] http://markaz.com/DesktopModules/CRD/Attachments/GCC%20Asset%20Management&InvestmentBankingReport2012-Executive%20Summary.pdf

Average Alpha based on Geographical Focus and Fund Size (2006 to 2011)

	MENA		GCC		KSA		Kuwait		UAE	
Size	# of Funds	Avg. Alpha	# of Funds	Avg. Alpha	# of Funds	Avg. Alpha	# of Funds	Avg. Alpha	# of Funds	Avg. Alpha
Very Large	0	-	0	-	4	3.4%	2	-3.0%	0	-
Large	1	4.2%	3	8.4%	5	3.8%	10	-2.3%	0	-
Medium	3	3.1%	9	18.5%	12	2.8%	4	0.1%	6	4.6%
Small	1	6.0%	2	13.1%	0	-	4	-5.7%	2	4.5%
Total/Average	5	4.1%	14	8.5%* 7.1%#	21	3.0%* 2.7%#	20	2.1%* -0.2%#	8	4.6%

Source: Zawya, Reuters Eikon, Markaz Research
*Conventional, # Islamic

If Active managers are generating Alpha, then possible reasons for the same

As indicated in the previous section, GCC fund managers, on average outperform their benchmark albeit large deviations exist among individual funds. We present below the possible reasons for alpha generation

Large Dividend Yields & Price Return Benchmarks

GCC countries offer handsome dividend yields with yields in top companies often being higher than the market average. Given this scenario, almost all local stock market indices are price return indices which unlike Total Return indices, don't account for dividends. This factor itself can easily account for fund manager outperformance given that indices compiled by index providers (MSCI, S&P etc) are so not popular for benchmarking individual country focussed funds.

Although we don't have clear results, Medium sized funds ($99-$10mn) seem to have outperformed other categories in terms of generating alpha

Dividend Yield

Exchange	Dividend Yield (%)
Saudi Arabia	3.29
Kuwait	3.23
Qatar	3.58
Abu Dhabi	5.42
Dubai	4.15
Bahrain	4.84
Oman	4.71
GCC Average	**3.77**

Source: Zawya, Reuters Eikon, Markaz Research

Low Level of Institutionalization

GCC capital markets are still evolving with retail and high net-worth individuals constituting a large part of the trading activity. The region's sovereign wealth funds have also evinced little interest in local stock markets. Foreign ownership limits is another factor which is hindering the participation of institutions. Lack of derivatives market and shorting mechanisms has deterred investors from taking advantage of arbitrage situations thus allowing mispricing's to last longer. All these factors made it easy for regional fund managers to beat the market and thus generate alpha for their investors.

The table below presents the market capitalization to GDP ratio of GCC markets along with other emerging and developed markets

Large Dividend Yields distort comparison as all local indices are price return indices

Stock Markets Comparison (2011)

Country	Year of Est.	No. of Listed Cos	Market Cap ($bn)	MCap to GDP (%)
UAE	2000	101	96	28.0
Oman	1988	120	20	35.8
Kuwait	1983	215	96	63.8
Saudi Arabia	1984	146	372	80.0
Qatar	1997	43	126	81.1
Bahrain	1989	44	22	90.0
India	1875	5,112	1,007	60.1
China	1990	2,063	4,763	81.0
USA	1792	4,279	17,139	117.5
UK	1801	2,056	3,107	138.3
Singapore	1973	659	398	166.2

Source: Stock Exchanges, World Bank, world-exchanges.org, IMF, Markaz Research

Information Asymmetry and Research

The GCC markets are information-inefficient with coverage from international databases yet to attain full scale. Additionally, the research environment remains underdeveloped with a handful of houses in each country putting out market/industry/company research. Coverage tends to be focused on large, highly traded companies while neglecting many of the smaller entities which only serve to perpetuate the shallowness of the market.

Research coverage across GCC (2H11)

Country	Percentage of Companies Covered	Market Cap Contribution (%) Jul-11 to Dec-11
Saudi Arabia	25%	76%
Kuwait	10%	61%
UAE	20%	64%
Qatar	30%	72%
Oman	15%	74%
Bahrain	7%	10%
Total	**17%**	**70%**

Source: Zawya, Reuters Eikon, Markaz Research

Information asymmetry is caused by large amount of private information being shared in informal meetings

Information asymmetry in the region is also caused by large amount of private information being shared in informal meetings. Such private news, which is not reflected in the price, leads to insider trading. Fund managers, usually with good contacts, will be able to benefit from such practices. Lack of stringent insider trading regulations is one reason why such incidents are widespread in the region.

Top Heavy Market Structure

Another aspect which helps active managers generate alpha is the shallow nature of the market. The top stocks account for a large part of the trading activity as well. Due to the concentrated nature, fund managers need to focus only those few large companies which matter the most. This reduced coverage universe makes it easy for managers to outperform the index as more time can be devoted to study the large companies.

Due to the concentrated nature, fund managers need to focus only those few large companies which matter the most

GCC Market Structure

Country	Number of Companies	Total Mcap ($bn)	Top 10 Cos - % of Total Mcap
Saudi Arabia	155	357	56%
Qatar	42	124	76%
UAE	110	103	65%
Kuwait	207	94	63%
Oman	118	19	62%
Bahrain	44	14	82%
Total	**676**	**711**	**63%**

Source: Reuters Eikon, Markaz Research

Underweighting Small Stocks

While fund managers are generally expected to find good opportunities and overweigh them, it is equally important to underweight bad stocks. The top heavy nature of GCC stock markets makes it a good case for underweighting small stocks. Underweighting of small illiquid stocks in an information-inefficient market will prove to be a good strategy for outperformance especially if the manager is benchmarked to a price index which gives index weights based on price of the shares rather than on market capitalization.

Can we expect the trend to continue?

We believe GCC fund managers will continue to outperform their benchmarks for the next few years. This is primarily because we don't expect any major change in the reasons which were outlined in the previous section.

Evolving capital market regulations, developing market infrastructure, and restricted environment for foreign investors are severe impediments to attract institutional money into the region. Although regional capital market authorities have taken cognizance of this and making efforts to boost investor sentiment, there has been little progress. Uncertain economic situation around the world is also restricting money flow into the region.

As competition increases, fund managers will find it hard to discover alpha generation opportunities

GCC Independent Capital Market Authorities

Country	Regulator	Year of Inception
Oman	Oman Market Authority	1998
UAE	Securities and Commodities Authority	2000
Saudi Arabia	Capital Market Authority	2003
Qatar	Qatar Financial Market Authority	2005
Bahrain	A division of Central Bank of Bahrain	2007
Kuwait	Capital Market Authority	2010

Source: Markaz Research

One event which could possibly make alpha generation difficult for active managers is the MSCI upgrade of GCC countries from 'Frontier' to 'Emerging'. Even though the amount of money flow is difficult to ascertain, the upgrade will be a sentiment booster for regional markets. As competition increases, fund managers will find it hard to discover alpha generation opportunities.

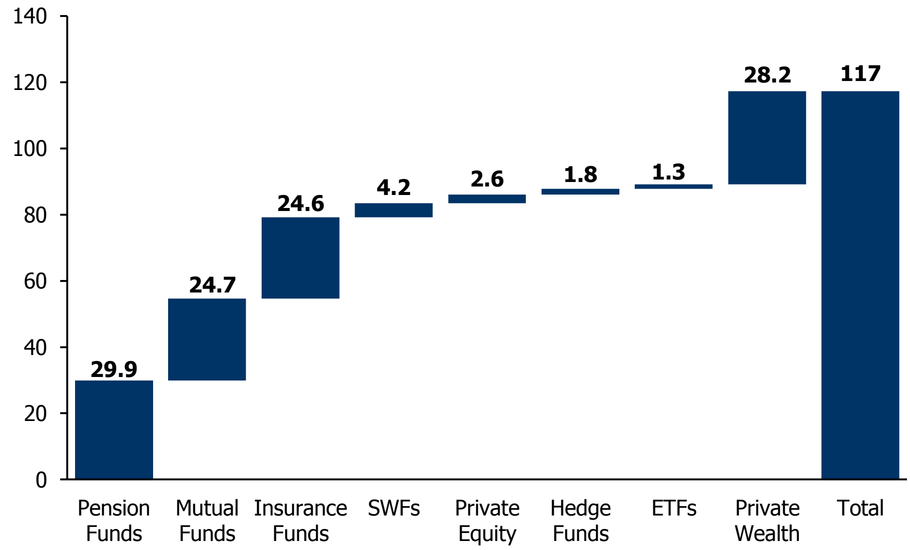
Mutual funds worldwide are estimated to manage USD 23.8tn in assets at the end of 2011

Another factor which can break the outperformance trend in the region is the lack of popularity of Index funds and ETFs. As more money finds its way to active managers, the resulting competition will make the search for alpha difficult.

International experience with Alpha generation

Mutual funds worldwide are estimated to manage USD 23.8tn in assets at the end of 2011 (2010: USD 24.7tn) and they constitute an important part of the global wealth management industry.

Global Wealth Management Industry – AUM in USD Trillions - 2010



Source: TheCityUK, Markaz Research

There has been enormous amount of research conducted internationally to ascertain if active managers outperform their passive counterparts. Each study has its own set of conclusions and there will never be a definitive answer to the active vs. passive management debate.

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- S&P's Indices Versus Active (SPIVA) Scorecard provides performance comparisons for actively managed U.S. equity, international equity and fixed income mutual funds. As per their 2011 scorecard, *"There are no consistent or useful trends to be found in annual active versus index figures. The only consistent data point we have observed over a five-year horizon is that a majority of active equity and bond managers in most categories lag comparable benchmark indices."*
- In a study by Optimum Solutions which encompassed more than 30,000 funds over 30 years, they concluded that
  - ❖ Without considering risk, active managers on average generated an excess return of negative 2.25% in bull markets, and generated an excess return of 0.86% in bear markets.
  - ❖ After adjusting for risk, active managers delivered a real alpha of 0.66% in bull markets, and a real alpha of negative 0.68% in bear markets.

A Lipper study reveals that about 40% of actively managed equity mutual funds in Europe generate Alpha

- A recent research conducted by Lipper reveals that about 40% of actively managed equity mutual funds in Europe generate Alpha, although the percentage varies widely over time and for funds investing in different regions.

Average Proportion of Funds' Rolling Returns Outperforming Benchmarks (1992-2011)

Category	1Yr Periods	3Yr Periods	10Yr Periods
All Equity Funds	42.8%	41.4%	39.7%
All Bond Funds	31.6%	24.7%	17.4%
Equity Asia Pac Ex-Japan	48.4%	48.9%	54.4%
Equity Emerging Mkts Global	38.5%	31.1%	24.6%
Equity Europe	37.7%	35.9%	27.0%
Equity Global	42.2%	38.4%	32.5%
Equity North America	36.2%	30.3%	20.8%
Equity UK	46.4%	47.6%	47.4%
Bond Emerging Mkts Global	45.8%	45.4%	--
Bond EUR	25.8%	18.5%	6.3%
Bond Global	34.4%	30.4%	23.1%
Bond USD	25.9%	16.8%	6.4%

Source: Lipper, Markaz Research

The report also points out that active equity funds in Europe manage about €1.5tn, while index trackers have €160bn and ETFs €139bn. Passive products make up less than 17% of total equity investments in Europe. The situation is no different in the US with index funds managing only about USD 1.1tn, of the total industry assets of USD 11.6tn[3]. GCC region also has a similar bias for active management. Active equity funds in the GCC manage close USD 10.6bn, compared to only USD 520mn in index funds[4].

Active fund management industry is still big since investors believe active managers face decreasing returns to scale

So, why is the active management industry so big when its performance has been so poor? Lubos Pastor of University of Chicago, in a paper titled "On the Size of the Active Management Industry" argues that investors believe active managers face decreasing returns to scale. *"Under decreasing returns to scale, investors adjust their allocation in response to performance, to achieve the desired expected return going forward. After a period of underperformance, the proportional allocation to active management should be smaller than it was at the beginning of the period, but it should also remain substantial."*

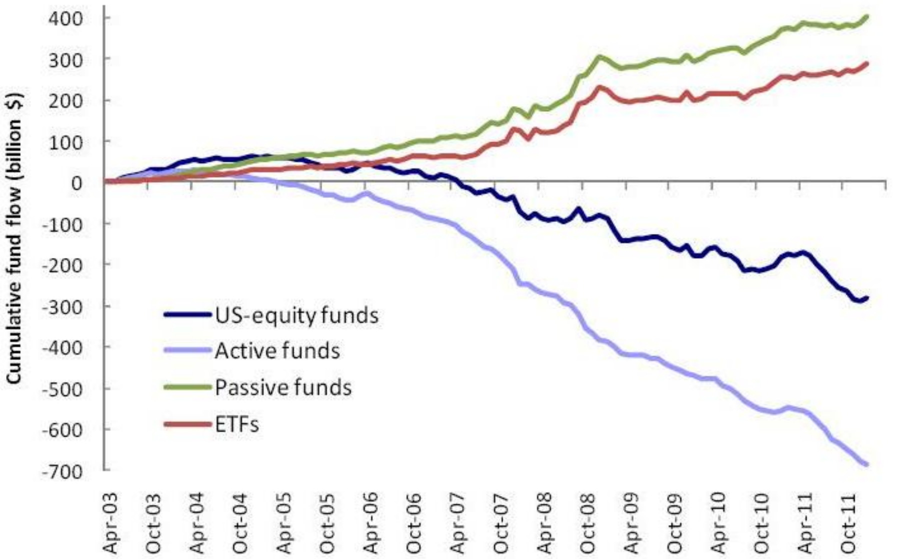
As per Pastor's research, the industry's Alpha decreases as the industry size grows because alpha becomes more elusive as more money chases it. When investors don't get the expected returns in any particular year, they tend to shift their alpha expectations downward and reduce investment in active funds but don't pull out all the money. Investors tweak their allocations slowly as they're uncertain about how steep returns to scale are.

[3] Investment Company Institute (ICI) 2012 Fact Book
[4] http://markaz.com/DesktopModules/CRD/Attachments/GCC%20Asset%20Management&InvestmentBankingReport2012-Executive%20Summary.pdf

This probably is the reason for smaller but an increasing share of the passive fund management industry.

Investors tend to shift their alpha expectations downward and reduce investment in active funds but don't pull out all the money

US Equity Flow – Active vs. Passive



Note: Shows cumulative fund flow into US-equity funds, active funds, passive funds and ETFs from Apr-03 through Jan-12.
Source: Nomura Securities International, EPFR.

Active fund management industry is still big since investors believe active managers face decreasing returns to scale

It is easy to comprehend that Alpha generation will become easier as the size of active fund management industry shrinks. As competition reduces, security mispricings will become frequent and active managers can take advantage of such situations to deliver alpha. So, is the growth of passive funds good for active managers? Probably Yes, for managers who can survive for long.

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