Overcoming Aerophobia

Conquering Fear to Take Advantage of Opportunity

By Douglas Clark Johnson

"Keep your seatbelts fastened and prepare for a bumpy ride and a hard landing," said Giovanni Bisignani, head of the International Airline Transport Association (IATA) in releasing scheduled results for last year. He may as well have been speaking for market sentiment as a whole. Most players to whom we speak - private bankers, institutional investors, asset managers - echo the same dire view. It is the rare investor who is now willing to put money to work boldly, if at all.

To follow through with our metaphor, given the potential for mid-air turbulence, only a minority of passengers are even willing to get on the plane. The rest are sitting in the terminal, despite the low probability that turbulence will cause the plane to careen wildly in the air.

Fear is a powerful emotion, especially when there is no sense of individual control. Most investors now feel they have no at-hand mastery over market outcomes. These players are simply not going to board the plane, no matter how hard you argue the facts.

Wisdom and Reason for 2009

Perhaps the best way to conquer that fear is to keep focused on key lessons from previous downturns. For sure, this may be the worst recession in our generation, but we can still learn from past experience. We offer three perspectives for navigating through this gust of air turbulence.

Bad Economies Are Not Necessarily Bad Markets

Investment gains presumably anticipate economic growth, based on relatively more positive demand expectations and business confidence. While no one seems prepared to be anticipatory nowadays - reinforced by a bleak employment outlook as financial-sector losses pummel the real economy - we can still find straightforward ways, perhaps representing non-speculative valuation, to put cash to work. We argue that there is virtue in simplicity.

Many of the best ideas coming out of the investment management business at this time are accessing so-called "opportunistic" situations. The more cynical among us might call these "distressed" ideas. Nomenclature aside, we argue that investors need to distinguish between distressed sellers and distressed investments. Many of the more prominent of these opportunities fall into the real estate and venture capital sector. Certainly these are not the only such situations. The impressive end-March rally in global equity markets may give us a taste of what to expect with some of these investments.

Research Should Be at the Forefront of Any Decision

The latter stages of the liquidity cycle saw a lot of investors placing their money indiscriminately. Those days are well behind us. Separating the stellar from the lackluster most assuredly will

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require higher expenditures on research and due diligence. Unfortunately, those Islamic firms launched during the most recent cycle may be averse to assuming such costs for the first time in a low-growth environment. We suggest that such a budget allocation may now be unavoidable, as investors move to exploit true inefficiencies in information flow.

The lack of research available through Islamic financial services organizations is a sign of the relative youth of the industry. Perhaps as the industry further comes of age, it will begin to focus more on analytical rigor. Making money will now require greater awareness of fundamental analysis, portfolio diversification and asset allocation. Presumably, the outcome will mean something more than simply saying the Islamic investors are "safe" because they do not invest in conventional bank stocks.

Themes Offer Portfolio Grounding

In our advisory and product-development work, we are now focusing on thematic opportunities, especially since we can identify elements that offer immediate affinity to the Islamic investor. These ideas move beyond stock-picking entertainment and are durable because they resist the wear-and-tear of market cycles. We group them in three meta-theme categories:

1. Approaches Focused on the Ummah

We see commonalities among frontier markets with dominant or sizeable Muslim populations, ranging from Bangladesh to Libya. There may also be opportunities associated with widespread urbanization and the securitization of remittance flows. Interestingly, given that remittance flows from workers may increase during times of economic crisis, the idea of securitizing these flows may be counter-cyclical.

2. Concepts Oriented to Industries

The life sciences area may be unusually relevant, given youthful populations. Energy-intensive industries such as steel and aluminum also have a role because of selected comparative advantage in low-cost energy sourcing.

One area that ties directly to concerns over global food security is agribusiness. We highlight opportunities afforded by cultivation and distribution. The concept may stretch from fertilizers to farm machinery to international wholesale trade. There may also be targets in livestock development.

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3. Ideas Based on Demographics

The burgeoning populations of the Muslim world require governments to address both infrastructure and home-ownership issues. The second concept relates to the proven role of property rights in economic development.

We also look to rural empowerment, given the dislocations of urban centers. Investment guidelines are driven by manufacturers and service providers looking to engage local communities. Early-stage targets may include textile-related firms and selected outsourcing enterprises.

One of the most powerful secondary arguments for thematic investing is that the opportunities are often cross-border in scope, affording some degree of geographic diversification. Infrastructure needs are as prevalent in Indonesia as they are in Egypt and Turkey. Rural empowerment is a singularly powerful concept across the broad swath of the Subcontinent. Even as such concepts span the Muslim world, though, we acknowledge that the current environment may limit what performance gains can be achieved.

As a sign of the delicate state of the global economy, the dire warning from the air transport chief referred to a 23% drop in December in year-on-year international air cargo traffic. That decline is about 50% greater than the one seen in September 2001, when much of the global airline fleet was grounded. The good news here is that the figure is a lagging indicator, likely representing order flow placed late in the third quarter and early in the fourth quarter of last year. Assuredly, turbulence will subside.

For the Islamic investor, a theme-based approach to portfolio structuring may appear hypothetical. Relatively few such investment funds exist, and the ones that do are most likely private-equity vehicles, with attendant redemption constraints. In practice, we may be limited to investing through subcomponents, such as individual securities or financing structures, batched through separately managed accounts. That process is fundamentally more time consuming than looking at a performance record.

We think the complexion of Islamic product offerings may be poised for change. Until recently, robust deal pipelines preoccupied most Islamic banks. And theme-based fund concepts require global professionalism; they do not, for the most part, conveniently fit into a single geography. Moreover, our themes do not easily translate into "bubble" funds that benefit from the advanced stages of a liquidity cycle. They probably do a better job of addressing investor unease than of inciting speculation.

Land of Yes

To follow through with our metaphor, it seems that our airline terminal has been built in the "Land of No." Investors have been gripped by fear, misled by tactics and whipsawed by news. Only a small minority seem to be living in the "Land of Yes." George Soros, for one, recently declared, "I'm having a very good crisis." As we move into the second quarter, sentiment seems to be taking a subtle shift for the better. Just recently, treasurers at a handful of different banks were willing to engage us in a lively discussion of some specific "long" opportunities. Granted, a few discussions hardly make a trend, but they do stand in sharp contrast to where sentiment was in the fourth quarter of last year.

Land of No	Land of Yes
Gripped by Fear	Driven by Opportunity
Misled by Tactics	Focused on Discipline
Whipsawed by News	Grounded by Themes

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Issues for Islamic Investors

Our recommendation is to "get on the plane" before the jet bridge is closed. Certainly the turbulence will subside. Indeed, we expect we will soon be on a final approach to the "Land of Yes." We offer three closing observations:

• Cash can be deployed constructively. Investors have fled to cash and cash-equivalent savings. In a world of opportunity, we suggest that there may actually be a horde of investment ideas in which to put these resources to work. In our own work, we have been surprised recently at the appetite for an Eastern European fund on which we're working.

• Home market bias may backfire. Shari'ah-compliant investors, especially in the Gulf, have been hesitant over the past cycle to diversify too broadly, citing generous returns at home. That strategy was not optimal, nor will it continue to be. Turbulence magnifies a "stay at home" instinct, at a time when investors should take advantage of depressed prices to build global positions.

• Shari'ah-compliance is not a cure-all. Simply managing a portfolio "Islamically" is not an adequate tactic for outperformance. Rather, quality, precision and due diligence matter. Many investors over the past cycle mistakenly took strong returns as a sign of their investor prowess, not liquidity trends.

Of course, there are a handful of airports for which commercial pilots have to be specially trained for landing rights. These may range from Bogata to Baghdad to Bhutan. While we might not elect to travel to some of these places, when we do, we are dependent on pilots' skill and precision, not to mention instincts, to arrive safely. Now may be a similar time to depend on specialist discipline.