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## **Food for Thought September 2011 – The Finances of the GCC Investment Industry**

The investment management industry in the GCC needs scale. Can it make a case for itself?

In previous Food for Thought notes we have looked at how GCC investment firms can position and differentiate themselves. In this note we put our local investment industry into the context of the global market for investment management and compare the financial aspects of running local and global investment firms.

McKinsey estimate that the total value of the world's financial stock, comprising equity market capitalisation and outstanding bonds and loans stood at \$212 trillion at the end of 2010, surpassing the previous 2007 peak.

Global managers operating in these markets are big and growing faster than the average firm by sales and mergers. The largest, BlackRock, manages nearly \$4 trillion, and all the rest of the top ten firms by AUM manage over \$1 trillion (\$1,000,000,000,000).

The market capitalisation for all MENA equity markets comes to about \$900bn, with around \$350 billion on the Tadawul while about \$125 billion is on ADX and DFM. The top ten global asset managers each run more than the value of all the MENA equity markets put together.

Markaz in Kuwait have done a study of GCC based investment firms and estimate the AUM in funds to be about \$30bn. If we assume there is around four or five times this much in discretionary portfolios, the total commercially managed money in the GCC is about \$150 to \$200 billion, with the Saudi market representing about half the assets managed in the region. These are commercial investment managers - we are not including SWFs or pension schemes, family offices, and the wealth management arms of banks or PE holding companies. We are also not including the staff of firms who are only selling funds run elsewhere.

In both the UAE and Saudi markets there is a high degree of concentration with a couple of key players dominating their markets. Across the board, this means that most firms' total AUMs are less than a lot of managers in mature markets have in a single fund. So what do the finances look like at these levels of AUM?

Around \$7 billion is managed in the UAE. Investit's estimate is that there are about thirty managers running client money invested in publicly quoted securities either on-shore or in the DIFC employing about 300 staff.

The numbers on the back of the envelope for the UAE look like this. For the sake of easy sums suppose UAE funds total as much as \$2 billion. Suppose half run at Total Expense Ratios of 1% and half at 2%, including admin and custody fees, so the income from these funds is \$30 million. Income from \$5 billion of discretionary mandates might be as high as 75 bps so add about \$38 million to give an industry income of \$68 million. For the 50% of firms running less than \$100 million this would give them revenues of \$1.5 million each. As the World Bank paper "Investment Funds in MENA" of 2010 pointed out, 'At this scale, management fees would be insufficient to support serious efforts at fundamental equity research and corporate governance oversight.'

Compare the entire UAE commercial industry with Schrodgers, a name well enough known everyone can identify with the story. Schrodgers manages about \$320bn depending on market

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levels. It employs 2,700 people and has clients and offices around the world. In 2010 it made profits of about \$600 million on income of \$1.6bn.

So Schroders runs and services about 40 times as much AUM as the whole UAE commercial sector. It does this with about 9 times as many people. Scale does not guarantee profitability but it does make it possible.

It is clear that very few investment management businesses in the GCC can be making profits. Equally regulatory filings with ESCA show that of the sixty or so active brokerages only four made a profit in the first half of 2011. While governments may wish to develop vibrant capital markets it is clear that at least one of the components is still very sub-scale. Barriers to entry were low, but barriers to success are now high.

Some managers might choose to sell up, if there is any value to realise. The diversified financial groups that have been combining PE, brokerage and fund management might begin to specialise in their areas of comparative advantage. About 50 brokerages have been closed in the UAE alone this year and we might see some similar reduction in the number of investment firms.

There are also other ways to reduce costs. We do not yet have a strong investment operations outsourcing offering in the region, but firms like GulfMENA are now promoting the concept of investment management outsourcing, so that investment managers with small asset pools can focus on client servicing and get rid of the disproportional costs of a subscale investment department.

However, with only \$150 billion in AUM attracted to local GCC investment managers so far we see the problem is not so much one of over-supply but of under-demand.

Developed markets have become sufficiently efficient that there is reasonable scepticism about the value of active investment management over holding some cheap beta exposure. But in contrast our GCC markets are still sufficiently inefficient that there could be a golden period for effective managers to exploit on behalf of local and global investors.

Global investors continued to diversify internationally - cross-border capital flows grew to \$4.4 trillion in 2010 after declining for the two previous years. There is money out there. Perhaps there are initiatives governments could take to bring more firms to market but governments don't owe our industry a living. Perhaps being 'promoted' to MSCI would force a lot of passive investors to hold stocks that global active managers do not actually find attractive enough to buy willingly, despite an emerging markets boom. That is hardly a ringing endorsement of the Gulf's investment opportunities. Managers who believe the Gulf offers investors opportunities that deserve a place in global portfolios need to reach out to investors and show their reasoned research.

From the collapse in volumes at GCC stock exchanges it is clear that local individuals now doubt their ability to make money in the market. For local investors managers have to explain clearly what they do and why they do it better than the investors have managed to do themselves.

If the industry is going to get to the scale required to thrive then investment managers have a case to make locally and globally; let's hear it.

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