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Socially responsible investing and Islamic funds: New perspectives for portfolio allocation

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ABSTRACT

The purpose of this paper is to investigate the performance of ethical and conventional investments. It examines also whether socially responsible and Islamic investments offer an additional opportunity for domestic investors to diversify their portfolios. Empirical results show that ethical investment ethical investment has inferior performance compared with their unscreened benchmarks. Moreover, using cointegration analysis, empirical results show the absence of long-run relationship between Islamic and conventional indices which offer new potential for portfolio diversification in local markets. However, there exist a long-run relationship between SR indices and their conventional counterparts. In the other hand, cointegration tests show that Islamic and socially responsible indices have long-run relationship only for FTSE indices.

1. Introduction

Investment optimization, pioneered by Markowitz (1952), aims at simultaneous maximization of the investor's capital and minimization of the risk of unfavorable events. According to the modern portfolio theory, an investor can reduce portfolio risk simply by holding assets that are not or poorly positively correlated, thus diversifying its holdings. This allows to obtain the same expected return while reducing portfolio volatility. Most portfolio optimization strategies result in investment diversification as it allows investors to decrease their exposure to the risk of single assets (Lintner, 1965; Elton and Gruber, 1977). So we can presume that when assets are correlated, the improvement of investment performance achieved by diversification is reduced.

Since the correlations of asset returns across countries are lower than within a country, the volatility of a portfolio's yield can be reduced, without sacrificing its expected return, by investing in overseas assets (see for example Chiou et al., 2009). However, the degree of international market integration is critical to the effectiveness of international diversification.

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The international stock markets have been influenced increasingly by globalization, especially developed countries which become more integrated. Campbell et al. (2001) suggest that the recent synchronized movements of stock price do not necessarily imply the disappearance of the benefits of diversification. This issue is being debated.

Due to the development of economic activity across borders, yields depend more on external factors (Forbes and Chinn, 2003). The consequence of this increasing integration of markets, formerly segmented, is to reduce the gains of diversification. Empirical literature on portfolios selection has revealed an apparent segmentation in the US and Europe stock markets (see for instance Balios and Xanthakis, 2003). Lessard (1973) finds that low correlation between developed and emerging equity markets proves that the benefits from international diversification are considerable for investors of industrial countries in emerging markets. Driessen and Laeven (2007) find that the gains from international portfolio diversification are larger for developing countries, in particular countries with high country risk. Bekaert et al. (2003), Guesmi and Nguyen (2011) consent this idea and state that these countries are less integrated in world financial markets. These authors advance that the world market is mildly segmented and that the degree of global market integration varies throughout time. In fact, the institutional and cultural heterogeneities among countries are key factors determining nonsynchronous movement of security prices among markets. Stulz and Williamson (2003) show that the liberalization and development of financial markets are related to cultural background such as major religion and language. Chiou et al. (2009) suggest that differences in cultural background, natural endowments, institutional systems, and legal traditions can generate gains from diversifying portfolio by deterring the international financial market integration. Barriers to foreign investment flows on emerging markets in order to preserve the control of national companies, the asymmetric information on securities in emerging markets, strong controls of exchange and the lack in free trade of those markets with international ones are constraints for investors who like to invest in emerging countries (Bekaert et al., 2003).

Moreover, in many countries, particularly developing ones, government regulations prohibit foreign investors from short-selling and/or holding more than a certain proportion of company shares. Measuring the potential benefits of regional diversification is of major interest for policy makers, since many countries are currently considering the setup of regional stock exchanges.

Besides, Medo et al. (2009) suggest that internationalized portfolios are not immune to asset correlations in today's globalized world where a single event can have worldwide implications. Chiou et al. (2009) affirm that when global markets become more integrated, it is natural to question whether international diversification still benefits for domestic investors. Investors often prefer to invest in familiar investment opportunities as opposed to foreign or unfamiliar investments (Huberman, 2001).

Although benefits of the international diversification exist when there are low correlations between stock markets, heavy costs and different constraints of investment abroad lead investors to think about other strategies of diversification especially in countries knowing growth of new area of investments like socially responsible investments and Islamic investments. A socially responsible investment (henceforth SRI) is an investment process which applies a set of investments screens integrating social, environmental, and ethical considerations. The idea of excluding companies according to a screening methodologies is of mutual interest between SRI and Islamic finance, but Islamic investors may be interested in different screening criteria (Wilson, 1997). Islamic finance refers to the types of investment that are permissible under the Islamic Law named as *Shari'ah*.

What is the impact on the profitability of the investment strategy of SRI share purchases? By the early 1990s, Hamilton et al. (1993) had established the terms of the debate by proposing three alternative hypotheses:

- the first is that SRI does not add or destroy value in terms of risk-adjusted returns, because corporate social responsibility is not priced;
- the second hypothesis is that socially responsible portfolios deliver lower expected returns compared to regular portfolios, because socially responsible commitments increase the cost of capital;
- the third hypothesis posits that the expected returns on stocks of socially responsible firms are higher than the returns on conventional stocks.

This paper contributes to the empirical literature by interesting in two principle objectives. First, we investigate whether sustainable and Islamic indices, considered in our sample, have different returns than the conventional ones. Second, we examine the hypothesis following that investment in the FTSE *Shari'ah* All-World Index, FTSE4Good, DJ Islamic Market and DJ sustainability indices offer a new perspective for local investment diversification, while allowing investors to respect fundamental ethical principles. The first objective has already been addressed in previous studies, the second objective is quite new. By studying the long-run relationship between socially Responsible (SR), *Shari'ah*-Compliant funds and conventional investment, we investigate whether there is a possibility to locally diversify investment portfolios which can help local investors to avoid additional costs of crossing borders and respect ethical principles.

The remainder of the paper proceeds as follows. Section 2 gives an idea about socially responsible and Islamic investments compared to the traditional one. Section 3 introduces empirical methodology. Section 4 reports and discusses empirical results. Finally, Section 5 concludes.