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ScienceDirect

Procedia - Social and Behavioral Sciences 219 (2016) 193 – 200

Procedia
Social and Behavioral Sciences

3rd Global Conference on Business and Social Science-2015, GCBSS-2015, 16-17 December 2015, Kuala Lumpur, Malaysia

Diversification: A Sharia Effect? Some Evidence From Malaysia

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Abstract

This study compares the effect of diversification between the Sharia and non-Sharia stocks listed on Bursa Malaysia during the period January 2002 to April 2014. The standard deviations of stock portfolios were calculated for the entire and two market phase defined bull and bear periods. Independent samples T-test indicated that there is significant difference in standard deviation between Sharia and non-Sharia portfolios for the bear and first bull period with no significant difference in the entire and second bull period. It can be concluded that portfolio diversification applies in both Sharia and non-Sharia compliant stocks of the Malaysian stock market. In addition, Sharia compliant stocks required a smaller number of stocks in a portfolio to reduce specific amount of risk.

Peer-review under responsibility of the Organizing Committee of the 3rd GCBSS-2015

Keywords: Diversification; Sharia portfolios; Bursa Malaysia; Bull market; Bear Market.

1. Introduction

Sharia defines activities that are not permissible for Muslims, such as consumption of pork, practice of riba, gambling, conventional insurance, and alcoholic production and sales. Sharia investors are thus limited to halal (permissible) securities and exclude companies which are haram (forbidden) or gharar (uncertainty) (Derigs and Marzban, 2008; Rahman, Yahya and Nasir 2010). Sharia investments are deemed different from non-sharia investments in terms of risks and returns. (Ahmad and Ibrahim 2002; Kassab and Morocco 2013). Sharia stocks are considered less risky due to the principles of Muamalat as well as the quantitative screening reducing the probability of default in payment of debt (Wee, 2012). However, requirements of low gearing and levels of liquidity may allow

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Peer-review under responsibility of the Organizing Committee of the 3rd GCBSS-2015
doi:10.1016/j.sbspro.2016.05.005

managers to escape market monitoring and encourage investment in negative cash flow projects (Jouaber, Salah and Rigobert, 2012; Rahman et al., 2010). Sharia investors could end up holding securities where the firms may have over invested in projects with little or no profits.

Systematic risks are macroeconomic factors such as interest rates, inflation rates and economic growth deemed not eliminable and non–systematic risks are microeconomic factors and can be reduced by forming portfolios.(Goetzmann and Kumar, 2001; Barber, Heath and Odean, 2003, Goetzmann, Massa and Simonov, 2004; Sutton, 2009; Bodie, Kane and Marcus, 2011). Islamic and non-Islamic stock indices are reported to be responsive to microeconomic and macroeconomic risks (Girard and Hassan (2008), Albaity and Ahmad (2011)).

Markowitz (1952) stated that portfolio size was often the root of diversification effect but there is no consensus on how many stocks is needed for a truly diversified portfolio (Markowitz, 1952, Perold 2004, Hight, 2009, Aleknevicience, Alekneviciute, Rinkeviciene 2012). In the classic studies of Evans and Archer (1968) and Statman (1987), it was concluded that 10 to 40 stocks are required to achieve diversification effect. Naïve strategy is one of an investor's preferred strategies (Benartzi and Thaler, 2001) and investors can expect that the variance of the expected returns is lower in the portfolio (DeMiguel, Garlappi and Uppal, 2009). This strategy will work particularly in the strong and semi strong market when information is widely available and allowing investors a chance to form a portfolio that performs even better than financial analysts (Malkiel, 1989; Dechow and Sloan, 1997).

Insignificant differences on the expected returns between Sharia and non-Sharia securities in Malaysia, Indonesia and the United States were reported by Statman, 2000; Hakim and Rashidian, 2002; Hussein and Omran, 2005; Albaity and Ahmad, 2011; Setiawan and Oktariza, 2013. Volatility of standard deviation is much larger in non-Sharia stocks and may explain why more non-Sharia stocks are needed to eliminate total portfolio risk (Chiadmi and Ghaiti 2012; Kassab and Morocco, 2013).

The term 'bull' and 'bear' are broadly used to explain the behaviour of stock market. Bull market indicates the period where major indexes gain at least 50% while, bear market, an index loss of at least 20% (Ho, 2012; Rieman, 2012; Planes 2013). There are also periods where the gains and losses could have offset one another that ended up in a flat market trend. Studies have suggested that Sharia and non-Sharia investment are different in terms of performance during the bull and bear market periods (Hussein 2005; Hussien and Omran, 2005; Sadeghi, 2008). The conclusions are mixed, with Sharia outperforming non-Sharia securities during the bear period (Abdullah, Hassan and Mohamad, 2007). Abdullah et al., (2007) suggested that conventional investment outperformed Islamic investment during the bullish market as conventional investors are able to invest in any stocks which involved high risk exposure activities. Hussein (2004) comparing FTSE Global Islamic index with FTSE All-World index reported that Islamic index underperformed during the bear period but achieved better performance for bull and whole period. Jouaber, Salah and Rigobert (2012) examined a set of Dow Jones Islamic indexes and reported that the difference between Islamic and conventional indexes is not affected by the bear and bull markets.

The paper has five objectives i) Does diversification works for both Sharia and non-Sharia stocks in Malaysia? ii) Is there a Sharia effect on diversification in relation to standard deviation? iii) Is there any difference in the number of stocks required to eliminate specific amount of risk for Sharia and non-Sharia compliant stocks? iv) Is there a market phase impact on diversification in relation to standard deviation? v) Is there any difference in the number of stocks required to reduce specific amount of risk for Sharia and non-Sharia compliant stocks during different market phase?

2. Methodology

There are a total of 905 securities as at May 2014 which consist of 673 (74%) Sharia securities and the remaining 232 securities are the non-Sharia stocks (www.sc.com.my). The Sharia Advisory Council Malaysia is responsible in the approving for companies to be listed as sharia securities on Bursa Malaysia. Due to the limit of listed non-Sharia stocks, 30 Sharia and non-sharia stocks in each category were selected. The sample period was from January 2002 to April 2014 and the peaks and troughs to identify the bull and bear markets were benchmarked based on the KLCI index. Data were extracted from Bursa Malaysia website and Data Stream using monthly log returns.