



Is there a financial news risk premium in Islamic stocks?



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ARTICLE INFO

Article history:

Received 17 September 2016

Received in revised form 7 January 2017

Accepted 22 February 2017

Available online 24 February 2017

Keywords:

Islamic stocks

Portfolio

Profits

Momentum

ABSTRACT

This paper examines whether there is a financial news risk premium in Islamic stocks. We utilize a unique data set that includes over 2000 stocks listed on multiple markets. Our main findings are twofold. First, simple trading strategies that buy high news sensitive portfolios and sell low news sensitive portfolios generate annualized returns of 4.92% to 12.48%. Second, we perform a momentum trading strategy for high and low news sensitive stocks and find that while both portfolios are profitable, investing in a portfolio of high news sensitive stocks generates an additional profit of 5.60% per annum. Our results are robust to different composition of portfolios, different momentum portfolio rules, and market risk-adjusted excess returns.

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1. Introduction

The profitability of Islamic financial markets has generated keen interest recently. This research has been motivated by the phenomenal growth of Islamic finance such that Islamic stocks are now widely accepted as an investment class. The growth of Islamic finance has been impressive. The interest in Islamic finance has been further accentuated by the recent research that shows that Islamic stocks are relatively more profitable than non-Islamic (conventional) stocks (see Narayan and Bannigidadmath, 2016; Ho et al., 2014).¹ Our paper builds on this investigation on profitability of Islamic stocks. Our goal is to examine whether financial news, which has been shown to predict Islamic stock market returns, contains a news risk premium. This is not a trivial issue because if there is indeed a news risk premium then this can be exploited through specific trading strategies that can potentially maximize profits from investing in Islamic stocks. Our research question can also be seen as providing a robustness test on the central question posed by the literature; that is, are Islamic stocks profitable?

Our approaches to addressing the proposed research question are twofold. First, we use the largest possible number of Islamic stocks that are constituent of the Dow Jones Islamic index. Our data set contains over 2000 Islamic stocks over the time period 1980 to 2012 (see Section 2 for details). We then merge this data set with the financial news data set of Narayan and Bannigidadmath (2016). This results in a unique stock-level data set consisting of Islamic stock returns and financial news that covers a 33-year time period. This allows us to undertake a historical empirical analysis of the sensitivity of Islamic stock excess returns to financial news. Based on this sensitivity of Islamic stock returns to news, each of the 2066 stocks are ranked from the most affected by news to the least affected. In the second step, using the news-sensitivity ranked stocks, we form 10 portfolios,

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¹ Studies have even shown that Islamic banking contributes to economic growth (see Imam and Kpodar, 2015); growth and welfare implications of Islamic banking have been studied by Kumru and Sarntisart (2016); and Gheeraert and Weill (2015) show that the development of Islamic banking has contributed to macroeconomic efficiency. In addition, Shaban et al. (2016) and Aysan et al. (2016) show that Islamic banks tend to lend favourably to small medium enterprises.

from high news sensitive stocks to the least. We then undertake a simple buy-sell trading strategy, where we allow an investor to buy high news sensitive stock portfolios and sell the low news sensitive stock portfolios. We conclude with a momentum trading strategy applied to a portfolio of stocks most affected by news (50% of stocks) and a portfolio of stocks least affected by news.

Our approaches offer two new results on Islamic stocks in general and on the role of financial news in particular. Our first finding is that financial news influences Islamic stocks and it has a heterogeneous effect on returns. The effect falls in the 0.86% to 2.13% per annum range. The implication is that there is a financial news-driven stock return story which may have economic significance for investors. Our second finding is that there is a strong financial news-based risk premium in Islamic stocks. The implication is that successful (profitable) trading strategies can be devised based on sorting portfolios on the basis of the sensitivity of stocks to financial news. When done, we find that investing in a portfolio of high news sensitivity stocks offers investors annualized returns in the 4.92% to 12.48% range. These results, based on a simple buy and sell trading strategy, are consistent with those obtained when using a momentum trading strategy which tells that the news-based return risk premium is in the 5% to 10% range depending on the trading strategy rule and the chosen portfolio holding period.

Our findings contribute to two strands of the literature. Our first finding that financial news influences stock returns connects with both the Islamic stock literature as well as the broader literature on asset pricing. In a recent study, [Narayan and Bannigidadmath \(2016\)](#), for instance, show that financial news predicts Islamic stock market index returns. We add to this study by showing that financial news affects a large number of stocks over the time period 1980 to 2012. Therefore, while [Narayan and Bannigidadmath \(2016\)](#) show the effect at the market level, our results are more detailed in that they are targeted at each of the stocks. More importantly, from the work of [Narayan and Bannigidadmath \(2016\)](#) one learns that financial news predicts Islamic stock market returns. From our analysis and results, one learns much more: while financial news affects stock returns, the effect is heterogeneous—that is, some stocks are extremely sensitive to financial news whereas other stocks are less sensitive such that in around 46% of stocks there is no statistical evidence that past financial news influences returns. The implication is not trivial. Given the sensitivity of stocks to news, a range of news sensitivity-based portfolios can be formed with the aim of guiding investment decisions. In this regard while [Narayan and Bannigidadmath \(2016\)](#) show using a mean-variance utility function that annualized Islamic market profits are 12%, we show that news sorted portfolios deliver heterogeneous profits, which fall in the 4.9% to 12.5% range. With these findings, we complement the studies that debate the profitability of Islamic stocks.² In this literature, to which our study directly relates to, studies such as [Al-Khazali et al. \(2014\)](#), [Ho et al. \(2014\)](#), and [Ashraf and Mohammad \(2014\)](#) find that Islamic stock indices outperform conventional indices during crisis periods but not during non-crisis periods. Therefore, these studies do not discover conclusive evidence that Islamic stocks are profitable.³ On the other hand, there are studies such as [Bialkowski et al. \(2012\)](#), [Hoepner et al. \(2011\)](#), and [Narayan et al. \(2015\)](#), who find relatively convincing evidence that Islamic stocks are profitable.⁴ We show conclusive evidence that Islamic stocks are profitable, and although this profitability is heterogeneous to types of portfolios, the results are robust.

There are two important differences between our study and the Islamic profitability-based literature alluded to above. The first difference is, as explained earlier, our micro-level (stock-level) analysis of profitability, which contrasts with the market-level analysis undertaken by the literature. The exception is [Narayan et al. \(2015\)](#); while they use stock-level data, they only focus on a small number of stocks (188 stocks) which have credit quality ratings compared to our 2066 stocks. The second difference is that we study Islamic stocks and their profitability from a financial news perspective. While financial news, as we explain below, plays an important role in influencing financial markets, none of the studies have considered the role of financial news in influencing the profitability of Islamic stocks in the manner we do.

Our second contribution connects with the broader financial news—stock returns literature (see, *inter alia*, [Engelberg and Parsons, 2011](#); [Garcia, 2013](#); [Tetlock, 2007](#); [Tetlock et al., 2008](#)). In this literature, it has been conclusively illustrated that financial news is a predictor of stock returns. In this paper, we take this as given and utilize this predictability information to sort stocks into portfolios that represent the degree of sensitivity of returns to financial news. With this approach we are able to test whether there exists a financial news risk premium on the Islamic stock market. We find evidence of significant financial news risk premium on Islamic stocks. Therefore, while the literature has shown the statistical importance of financial news by way of predictability, we show the economic importance of financial news. Specifically, we show how financial news can be used as an instrument for devising successful trading strategies for investing in Islamic stocks. With our paper, therefore, we have both a statistical as well as an economic significance story. We believe that our analysis adds completeness to the role that financial news plays in influencing stock returns.

The rest of the paper is organized as follows. In the next section we explain our data set. In section III we present the results, while in the final section we provide a summary of our main message.

² By debate, here we mean that studies have documented mixed results on whether or not Islamic stock markets are profitable than conventional markets. Naturally, these mixed results are due to different sample sizes (time-series and panel data), different country focus, different sample periods of data, different estimation techniques, amongst others. Indeed, given the large number of studies on Islamic finance, it will be timely to undertake a survey of this literature—a task we leave for future research.

³ Complementing these studies is the work of [Hayat and Kraeussl \(2011\)](#) who show that Islamic equity funds tend to underperform Islamic and conventional indices.

⁴ In related studies, portfolio diversification benefits for Islamic investors have been shown by [Rahim and Masih \(2016\)](#).

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