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Full Length Article

Investment strategies with rebalancing: How could they serve Sukuk secondary market?

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Abstract

Although the Sukuk market is rapidly growing, it still faces many challenges. The “Buy and hold” effect slows down this growth as it freezes the exchange of these assets in the secondary market. In this perspective, this paper introduces an approach aiming at improving Sukuk exchange by using the diversity of the investors' risk profiles. Through this study that applies several investment strategies based on rebalancing, we demonstrate that these strategies have the potential to boost the Sukuk market's growth. This is actually due to the fact that the investor can choose among these strategies according to his investment profile and his market anticipation. However, this approach's effectiveness is conditioned to the adherence of a large number of investors. In terms of contribution, this paper fills the gap in the literature by introducing a pragmatic approach to reduce the impact of the “Buy and Hold” effect on the Sukuk market.

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1. Introduction

According to the Accounting and Auditing Organization for Islamic Financial Institutions, Sukuk are defined to be investment certificates representing an undivided property in a tangible asset or in a well-defined project. Their market is currently dominating the Islamic financial industry. Indeed, in the third quarter of 2016, the Sukuk market reached a total issuance of \$ 39.8 billion and a total outstanding amount of \$ 368.2 billion. Thus, Sukuk represent a share of 17% of Islamic finance assets. They hold the second position after the Islamic banking sector (Thomson Reuters, 2016).

Sukuk market is the fastest growing field in the Islamic financial services industry with an increase of about 20% per year over the period 2008–2014 (Naifar, Mroua, & Bahloul,

2017; Reboredo & Naifar, 2017; Smaoui & Nechi, 2017). However, the development of the Sukuk market still faces several challenges, such as the “Buy and Hold” effect (Godlewski, Turk-Ariss, & Weill, 2010; Jobst, Kunzel, Mills, & Sy, 2008; Siddiqui, 2008). This is due to the fact that the majority of Sukuk holders held them to maturity (Zulkhibri, 2015).

The “Buy and Hold” effect, which consists in the purchase of an asset and keeping it to maturity, represents a dominant behavior of investors. This passive strategy is called a “Buy and Hold” strategy. Generally speaking, it is a long-term investment choice based on a bullish market forecast (Barberis, 2000; Fernandez-Rodriguez, Gonzalez-Martel, & Sosvilla-Rivero, 2000; Shiryaev, Xu, & Zhou, 2008). For an investor, this strategy is not a problem per se if it reflects its intention to manage a particular asset. Once we consider an asset portfolio, this strategy may have undesirable effects (Willenbrock, 2011). Indeed, the allocation of assets differs from the initial allocation following market fluctuations. The resulting

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portfolio may differ from the investor's risk profile represented by the weight of each asset in the portfolio. Thus, portfolio adjustments should be made if the investor intends to maintain its risk profile (Willenbrock, 2011). At market level, the majority of investors' adherence to this strategy freezes transactions in the secondary market (Jobst et al., 2008; Siddiqui, 2008). As a result, several consequences related to asset liquidity are generated such as the increase of transaction costs, bid-ask spreads and price inefficiency (Amihud, Mendelson, Pedersen, & others, 2006).

Despite its impact, only few studies propose pragmatic approaches to reduce the “Buy and Hold” effect. Actually, unlike bonds literature, Sukuk literature reveals a dominance of qualitative studies over quantitative ones (Aliyu, Hassan, Yusof, & Naiimi, 2016; Zulkhibri, 2015). However, few studies analyze Sukuk as an investment instrument instead of focusing on their structuring. Moreover, in our humble knowledge, none of the existing studies have suggested a pragmatic solution to the « Buy and Hold » effect. Only Najeeb, Bacha, & Masih, 2016 investigate diversification opportunities for Sukuk portfolios across heterogeneous investment horizons, assuming that investors would maintain a “Buy and Hold” strategy.

Among qualitative studies, Tariq & Dar, 2007 show that different perceptions of Sharia (Islamic law) in Islamic finance impact Sukuk pricing. Thus, a financial engineering compliant with Sharia would enhance the attractiveness of these instruments. At the operational level, Shafi, Ariffin, & Salamudin, 2013 suggest the use of convertible Sukuk to mitigate investors risk especially when they are backed by tangible assets such as real estate. Furthermore, participatory Sukuk are more adapted to well-informed investors since they are usually more exposed to return risk than to credit risk (Wilson, 2008). Concerning quantitative studies, we distinguish three streams of research. The first one analyses the comparability between Sukuk and bonds. In fact, Cakir & Raei, 2007, pp. 1–20 affirm that bonds are different from Sukuk since their prices do not have the same behavior, which is confirmed by Godlewski et al., 2010 as well. Indeed, they identified a negative correlation between equity and Sukuk market but found no correlation between this market and bonds issuance. Moreover, Ariff & Safari, 2015 also confirm the difference between the two investment instruments by conducting a cause-and-effect study on their prices. In addition to that, some empirical studies show how similar is the relation between Islamic equities and Sukuk to the one linking conventional stocks to bonds (Masih, Kamil, & Bacha, 2016).

The second stream highlights the impact of macroeconomic factors on Sukuk market using the Multiple Regression and the Vector Autoregressive model (VAR). For instance, Ahmad, Daud, & Kefeli, 2012 affirm that the development of Sukuk market has a positive impact on the Gross Domestic Product (GDP) of Malaysia. In addition to GDP, Said et al., 2013 emphasize the relation between this market and several other factors such as the size of Muslim population, the quality of regulation and economic crises. Smaoui & Khawaja, 2016 added some other factors like lower corruption and interest

rate spread. The third one focuses on the volatility of this market using Sukuk Dow Jones index as a proxy. In these studies, EGARCH is the prevalent model. It allows detecting the impact of shocks on the Sukuk market. Indeed, Nursilah & Sulistya, 2013 demonstrate the existence of a systemic effect between this market and other ones. Therefore, an investor has to take into consideration the information available at the overall market level and not only at the Sukuk market.

In this paper, we will contribute to the on-going studies on Sukuk Market by exploring the benefits of investment strategies based on rebalancing in improving exchange in Sukuk secondary market. An investment strategy is typically linked to an investor's risk profile. Generally speaking, every financial market is characterized by a diversity of investors and thus different risk profiles. In conventional financial markets, several investment strategies are developed in order to reflect this diversity. Many of these strategies are compatible with the Sharia and can be implemented within the Sukuk market. In this perspective, this work aims at stimulating trading in the Sukuk market by applying the existing investment strategies. In fact, we show through this study that the “Buy and Hold” strategy is not always optimal, which will encourage investors to adopt other strategies intrinsically. The remainder of this paper is structured as follows. The first part reviews the literature on the Sukuk market and addresses the impacts of the “Buy and Hold” effect. The second part presents Sukuk universe and the principle of different strategies used in our empirical study. Results and limitations are discussed at the end of this part. And the last part concludes the paper.

2. Literature review

The purpose of this section is to introduce Sukuk as an investment instrument with different types, risks and methods of rating. We will also highlight some factors that may be related to the passive behavior of investors by adopting a “Buy and Hold” strategy.

2.1. Sukuk Market

Similarly to bonds, Sukuk pay periodic coupons and have a fixed maturity (Ahmed, 2010; Godlewski, Turk-Ariss, & Weill, 2013, 2016). They were issued for the first time in the 1980s (Godlewski, Turk, & Weill, 2011, 2013). Sukuk market is currently experiencing strong growth with an overall issue volume of 39.8 billion US dollars in the third quarter of 2016. The Malaysian market, only, represents 58.19% with an issuance volume of 23.1 billion US dollars (see Fig. 1) (Thomson Reuters, 2016). Thus, Sukuk are considered as the most interesting instrument in Islamic finance (AL-Hersh, 2014).

Sukuk provide the opportunity to invest in several assets and projects. Their performance depends on their underlying's. Usually, they are called “Islamic bonds” but they are different from bonds conceptually speaking. The exact translation defines them as “Islamic Investment Certificates” (Afshar, 2013). Also, Sukuk investors are considered to be not

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