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Global risk exposures and industry diversification with Shariah-compliant equity sectors

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ABSTRACT

This paper examines the risk exposures of ten major Islamic sector indexes with respect to shocks in global conventional markets. Utilizing a dynamic three-regime, three-factor risk spillover model, we generally observe positive risk exposures of Islamic equity sectors with respect to developed market shocks. Consumer Services, Oil & Gas and Technology, however, are found to exhibit negative risk exposures during crash periods, implying possible safe haven benefits for global investors. Both in- and out-of-sample results suggest that the portfolios supplemented with positions in Islamic equity sectors yield much improved risk adjusted returns, implying significant international diversification benefits. Financials, Healthcare, Telecommunication, and Utilities particularly stand out with relatively higher weights allocated in the optimal portfolios, implying the significance of these Islamic sectors in global diversification strategies.

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1. Introduction

The Islamic financial industry is viewed as an alternative investment to the conventional counterpart in the world of financial intermediation because it may bring diversification and financial stability. This Shariah-compliant industry has experienced significant growth over the past two decades, with an increasing number of equity and debt (sukuk) securities offered in financial markets worldwide including North America, Europe, Asia and the Middle East and North Africa (MENA). The growth has been reinforced in the wake of the 2008–2009 global financial crisis (GFC) which wreaked havoc on conventional markets.

At the end of 2012, the total value of Islamic finance assets under management was estimated at US $1.6 trillion and approximately US $1.8 trillion at the end of 2013. They are estimated to reach the US $2 trillion mark by the end of 2015. These are also predicted to reach US $6.5 trillion by 2020.[1] Similarly, the global emerging sukuk (Islamic bond) market was expected to reach US $131.2 billion. At the end of 2012, the size of the Islamic banking assets that have been the main driving force of the global Islamic finance industry reached US $1.27 trillion. The asset allocations in the Islamic funds are composed of 46.9% equities, 22.2% money markets, 11.8% mixed assets and 9.0% real estate.

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[1] These numbers come from various sources including Bloomberg and Kuwait Finance House Research Ltd.

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Islamic equity securities are viewed to be less risky than their conventional counterparts, largely due to their relatively low leverage ratios, the restrictions on investable industries and on the use of financial derivatives which might be related to speculative transactions. Investments in the Shariah-compliant assets are considered in line with the socially responsible and ethical investments (Saida et al., 2013; Abdelsalam et al., 2014). Shariah compliance requires that Islamic equity finance follows two sets of screens. The first set eliminates any companies with involvement in activities such as alcohol, tobacco, pork-related products, gambling, entertainment, weapons, and conventional financial services. These activities are prohibited by Shariah rules since they are not considered to be conducive to the society's welfare. Shariah rules also prohibit dealing with activities that involve *Riba* and *Gharar* (Berg and Kim, 2014). Although the term *Riba* has no precise translation in English (El-Gamal, 2006), it can basically be interpreted as the premium (or interest) that should be paid by the borrower to the lender along with the principal. The term *Gharar* on the other hand refers to transactions that involve the sale of risk or trading in risk which may result in the creation of doubt or deception (El-Gamal, 2001). These rules view the creation of wealth for one party at the expense of another as unjustified and against the general interest and welfare of the society. Consequently, speculation and short-selling in stocks are also not allowed under Shariah rules (Kamali, 2000). The former is considered to be hazardous that harms more than benefits, while the second is regarded to involve selling what is not in one's possession and involves uncertainty. Finally, risk management or risk reduction techniques such as hedging and insurance are not allowed in Islam.

On the other hand, the economic interpretations of Riba and Gharar have often been open to interpretation and it can be argued that almost all business transactions involve some form of Riba and Gharar. Consequently, if these rules are applied literally to Islamic investments, the number of companies eligible for investment under Shariah rules would virtually be equal to nil. Therefore, Islamic scholars have established a set of financial rules that utilizes financial ratios to screen and filter companies to be included in Islamic equity indices. First, the company's debt ratio must not exceed 33% of total assets. Second, the ratio of accounts receivables to total assets must be below 45%. Third, any income generated from interest must equal to or less than 5% of total revenue. The process of prohibiting interest income does not halt at the enforcement of those rules. Any interest income spawned from interest-based sources is identified and must be given out for charity. This process is known as 'cleansing'. Equally, preferred stocks and the receipt of fixed dividends are also considered unlawful.

In short, the Shariah-based rules lead to the elimination of a number of investments including speculative financial transactions such as those involving financial derivatives that have no underlying real assets, government debt issues with a fixed coupon rate, hedging by forward sale, interest-rate swaps and any other transactions involving items not physically in the ownership of the seller (e.g., short sales). To that end, it can be argued that Islamic equity markets may be largely segmented from their conventional counterparts as they avoid much of the fundamental risk factors, some of which had contributed to the recent global financial crisis. Thus, a natural research question is whether these unique features of Islamic securities lead to the segmentation of this market segment from conventional markets and whether this segmented nature can offer significant international diversification benefits for investors in global markets.

This paper contributes to the literature in several ways. First, it extends the emerging literature on Islamic equity markets by examining risk exposures of ten major Islamic equity sectors with respect to shocks in global markets and their conventional sector counterparts, which to our knowledge has not been done before. This contribution is important due to the considerable sector rebalances that occurred in response to the losses suffered in the conventional equity sectors during the recent crisis and post crisis periods. The industry focus in the current study is further motivated by Moerman (2008) stating that industry-based diversification yields more efficient portfolios than country-based diversification. Therefore, extending industry diversification to Islamic equities offers a new perspective to the literature.

Second, the paper proposes a generalized three-factor spillover model to explore the Islamic and conventional equity sectors' sensitivity to shocks in global conventional markets. The three-factor spillover model distinguishes between shocks to advanced and emerging markets as well as shocks in the corresponding conventional equity sectors. By doing so, the model provides inferences regarding the possible segmentation (or integration) of Islamic equity sectors from (or with) the conventional equity markets and allows us to make inferences regarding the industry diversification benefits of Islamic versus conventional industries. For this purpose, we cover ten key sectors including Technology, Financials, Industrials, Utilities, Basic Materials, Consumer Goods, Oil & Gas, Healthcare, Consumer Services, and Telecommunications. Third, the paper offers a dynamic analysis of risk transmissions over three market regimes, low, high and extreme volatility, as suggested by the data. The dynamic spillover model takes the time-varying and regime dependent nature of the interactions across developed and emerging markets as well as global and Islamic sectors in a robust framework with flexible regime-switching structure. Thus, the dynamic approach allows us to examine whether Islamic sectors could serve as a diversifier or a safe haven for global investors during different market regimes. Finally, the study provides evidence on the in- and out-of-sample performance of dynamic portfolio strategies in which the global portfolio is supplemented by positions in the Islamic equity sectors and provides insight to the international diversification benefits of these assets.

Our findings suggest that Islamic sectors generally but with some exceptions exhibit positive risk exposures with respect to developed market shocks, implying that Islamic sectors in general are not isolated from developed equity market fundamentals. The sectors Consumer Services, Oil & Gas and Technology are however found to exhibit negative risk exposures during extreme market volatility periods, suggesting that these three Islamic sectors could serve as a safe haven for investors in developed markets during periods of market crisis. We also observe a significant "industry effect" in Islamic equities, particularly in the case of Consumer Goods and Consumer Services sectors, while Islamic Financials are found to show the lowest level of risk exposure to shocks in the global (conventional) financial sector, suggesting some degree of separation from the conventional financial system. Interestingly, Islamic financials are found to be mostly driven by its own sector specific fundamentals, possibly due to the investment filters in places that affect financial firms the most.

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