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Performance of global Islamic versus conventional share indices: International evidence

Catherine Soke Fun Ho [*,1], Nurul Afiqah Abd Rahman, Noor Hafizha Muhamad Yusuf, Zaminor Zamzamin

Universiti Teknologi MARA, Malaysia

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ABSTRACT

This paper provides empirical evidence on risk-adjusted performance comparisons of share indices from Islamic and conventional markets. To ensure valid comparisons, the selected Islamic indices are matched with conventional indices. The Treasury-bill rate and the MSCI All-World index are used as risk-free rate and world benchmark, respectively. Monthly returns are analyzed and four sub-periods are examined as crisis and non-crisis periods. Findings reveal that Islamic indices outperformed their conventional counterparts during crisis periods but results are inconclusive for the non-crisis periods. This could be due to the conservative nature of Shari'ah-compliant investments offering investors superior investment alternative during crisis.

1. Introduction

The markets for both conventional and ethics-filtered investments have developed rapidly as new investment instruments over the last two decades. These investments have not only expanded in the conventional capital and money markets but also in the recently-developing Islamic financial markets. Over the past decade, the global capital market scene has witnessed the introduction of Islamic indices, which are designed to filter out the stocks in conventional indices in accordance with the doctrinal

* Corresponding author at: Institute of Business Excellence, Arshad Ayub Graduate Business School, Faculty of Business Management, Universiti Teknologi MARA, Malaysia. Tel.: +60 3 55444792; fax: +60 3 55444693.

E-mail address: catherine@salam.uitm.edu.my (C.S.F. Ho).

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position of Islamic laws that introduces a number of ethical considerations for an instrument to be considered as ethically-acceptable. Some of the indices are: Financial Times Islamic Index Series (FTSE), Dow Jones Islamic Market Index (DJIM), Standard & Poor Shari'ah Index (S&P) and Morgan Stanley Capital International Islamic Index (MSCI).

The dedication shown by the global index providers to offer Islamic indices has provided evidence that Islamic investors are showing greater selectivity in their investment choices. Global index providers have shaped these new indices in slightly different ways to take into account different expectations of regulators of both Islamic and conventional markets. It is interesting to note that there has been tremendous interest in Shari'ah compliant investments and indices, mainly due to their more equitable and profit-sharing nature, which draws considerable research interest in recent years. The fastest growing segment of the global financial industry is reportedly Islamic investments, which is alleged to yield good returns and is based on desirable ethical precepts desired by some investors in Islamic countries. Global Islamic financial asset is estimated to reach USD1.8 trillion by 2013 (GIFF, 2012).

Investment in global capital market could benefit from diversification alternatives in both conventional and Islamic instruments. Most investors find that the easiest and most efficient way to improve return is to invest in various indices, especially Islamic ones which are more transparent with lower risks. Financial philosophy however casts doubt on the ability of Islamic indices to perform as well as conventional ones due to the smaller size of the investment pools relative to the conventional asset markets. Given its lower diversification potential as well as the higher costs of Islamic compliant portfolio selection, one may suggest that these investments would underperform the conventional ones (Bauer et al., 2005). The motivation of this paper is to report findings from a comparative study of both types of investments since this issue has yet been bedded down. In addition, there are reports that Islamic banks did not suffer as bad as the conventional banks during the 2008–9 global crisis. This study therefore sets out to examine performance of indices by controlling the effects of crisis as well as testing performance during and after crisis periods.

The next section provides a brief background of the Islamic financial market and the rest of the paper proceeds as follows: Section 2 reviews related studies while Section 3 discusses the data and methodology. Section 4 describes the empirical results and Section 5 provides a summary and concludes the paper.

1.1. Background on Islamic financial markets

Islamic stock market indices have gained popularity due to the greater potential of growth and profitability (Hassan and Girard, 2011). These indices are designed to comply with Islamic ideology and the management of funds is strictly regulated to avoid fee-gauzing and other means of unethical transfers to operators. It is important to understand the criteria for Shari'ah compliance and the rules and regulations for such investments relative to the conventional ones. The Shari'ah Advisory Board (SAB) is the highest authority that provides the guidelines and regulations where investments in Islamic compliant businesses must be based on the Islamic principles of transactions referred to as *Muamalat*. Screening of compliance in accordance to a set of ethical and trading restrictions are in place. There are two broad Shari'ah principles: the sector-based screens where business activities are checked to ensure that they are not involved in any non-Shari'ah compliant activity (some of them are: production of pork and alcohol for human consumption; gambling; interest-based conventional financial contracts; advertising/media involving pornography; tobacco and trading of gold and silver as cash on deferred basis).

Once companies with non-compliant business activities are removed from the index, the rest of the companies are examined according to the accounting-based screens for compliance to financial ratios. Some of the compliance measurements that companies must conform to include: debt to equity must be less than 33%, accounts receivables to equity should be less than 49%, cash and interest bearing securities to equity must be less than 33%. In addition, revenues from non-compliant activities are permissible as non-permissible Income to revenue if they comply with certain threshold: a maximum of 5% is permitted (Ho et al., 2011, 2012).

In the recent decades, the world Islamic financial market has gathered significant momentum in attracting international capital flows from both Muslim and non-Muslim investors, and the favored indices are the global Islamic indices such as FTSE, DJIM and MSCI. Moreover, the development of Islamic capital markets in domestic and global markets continues to show positive trends. This is partly caused by Islamic