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Matching perception with the reality—Performance of Islamic equity investments

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ABSTRACT

The systematic failure of the global equity markets during the recent financial crisis made investors re-evaluate their portfolio constituents. It is argued that equities that comply with the Islamic investment principles perform better than conventional equities during the declining phase of capital markets. The better performance of Islamic investments can be attributed to the *Shari'ah* based screening criteria that specifically forbids investment in shares of those companies that are excessively leveraged and/or engaged in lending activities. This study investigates the extent to which this claim is valid by comparing the performance of global and regional Islamic equity indices (IEIs) with conventional equity indices during the past decade. The equity indices for such analysis are preferred since it does not account for transaction costs or management skills. A logistic smooth transition autoregressive (LSTAR) model is used to investigate whether the 'down market' performance of IEIs differs from conventional indices. The LSTAR is superior to conventional ordinary least squares models since this allows for a smooth transition from the 'down market' to the 'up market' rather than an abrupt change. The empirical results indicate that IEIs, in general, perform better than conventional indices during the period 2000 to 2012. We do not find any abnormal returns associated with Islamic equity indices on a global basis, however, there is evidence of positive abnormal returns in the case of regional indices from Europe and Asia. Overall, IEIs exhibit lower systematic risk as compared with their benchmark suggesting that any excess performance from Islamic investments stems from the systematic risk that each investment assumes with respect to their benchmark during the declining phase of capital markets. The findings of this study are of interest to both academics and the general investing public since it provides evidence that IEIs are comparatively less risky than their

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conventional counterpart and thus provide hedging opportunities during the downfall of capital markets.

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1. Introduction

Islamic equity investment based on Islamic Jurisprudence (*Shari'ah*) principles has gained considerable attention in academia as well as in the popular press during the recent global financial crisis. It is noted that speculative trading and unsafe lending practices adopted by major international banks were among the major causes for the global financial crisis (Cyree et al., 2011; Caprio, 2009; Ashraf and Goddard, 2012). *Shari'ah* principles specifically forbid investment in any company engaged in transactions based on usury (*reba*), excessive risk taking such as trading in derivatives and insurance (*gherar*), gambling activities (*meiser*), trading in alcohol (*khumar*), and/or pork products. *Shari'ah* principles allow investments in lower leveraged companies and financial instruments linked with real assets (sukuk). The restriction on leverage[1] and trading in financial assets including derivatives may result in a very different risk adjusted performance of Islamic equity investments from that of similar conventional investments during the downturn of capital markets.

Most major global commercial banks and investment firms, both in Islamic as well as in non-Islamic countries, provide investors with the opportunity to invest in funds that comply with *Shari'ah* principles of investments. All major index service providers: the Financial Times Stock Exchange (FTSE), Standard and Poor's (S&P), Dow Jones and Morgan Stanley Capital International (MSCI), now build and provide Islamic Equity Indices (IEIs) data based on independent *Shari'ah* screening criteria at global, regional and country level. Ernst and Young (2011) estimates that there are currently more than 700 mutual funds globally investing in *Shari'ah* compliant securities. The aggregate value of Islamic equity investments internationally has grown to USD 58 billion in 2010 from USD 3.3 billion in 2003 (Ernst and Young, 2011).

Globally, assets under management (AUM) of Islamic mutual funds represent less than one percent of the USD 25.92 trillion global mutual fund market. However, with the onset of the global financial crisis (GFC) in 2008, Islamic investment funds have gained popularity due to the recent empirical evidence from different countries that such funds are resilient in the downturn of the economy due to their investment in companies engaged in businesses based on real assets and lower leverage (Alam and Rajjaque, 2010; Ashraf, 2013; Hoepner et al., 2011; Merdad et al., 2010). Aside from the equity performance, managers of IMFs have more leverage on market timing and stock selection since they may not face heavy drawdowns during bearish trends as profit seeking is not the main investment objective for an investor in Islamic funds. Rather, investors seek to satisfy a broader cause of adhering to their faith (Ashraf, 2013). However, Hayat and Kraeussl (2011) found that Islamic mutual funds perform worst in either a bullish or a bearish economic market as compared with conventional funds.

The performance evaluation of Islamic equity investments based on mutual funds may be biased due to fund managers' discretion in stock selection and market timing abilities, along with associated trading costs. Schröder (2007) suggests that index level data provides a better performance comparison of screened indices with that of conventional indices since management skills, transaction costs and/or market timing activities of fund managers or the risk profile of investors has no bearing in the performance of the index. Any abnormal return or lower volatility can be attributed to the specific screen used to isolate equities.

This paper seeks to explore whether Islamic equities perform better than conventional investments during a downturn of the economy on a risk adjusted basis. For this purpose, monthly equity index level performance data for 24 indices (12 IEIs and 12 conventional indices) from global and regional equities has been collected and matched from three major equity index providers: MSCI, S&P, and Dow Jones from June 2002 to May 2012.

The existing literature on the performance of IEIs does not consider any performance deviation under different market conditions such as ‘bull’ and ‘bear’ nor does it isolate the intertemporal impacts on the

[1] Leverage is not forbidden completely in modern day investments. *Shari'ah* boards, consisting of Islamic scholars, have allowed up to 33% of capital finance by debt.

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