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Market integration between conventional and Islamic stock prices

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ABSTRACT

The paper assesses the market integration between conventional and Islamic stock prices from the long- and short-run perspectives for France, Indonesia, the UK and the US from September 8, 2008 to September 6, 2013 using various econometric approaches. The results show long-run relationships for all countries, except for the UK where there is no cointegration between conventional and Islamic stock prices. These findings suggest that the Islamic finance industry in the considered economies (except the UK) does not seem to be compliant to Islamic law's maxims, which hinders portfolio managers and market participants to benefit from the opportunities of international diversification and hedging effectiveness. From the correlation perspective, there is evidence of weak linkages between the Indonesian market and the developed markets for both conventional and Islamic stock prices, thus suggesting that investors can diversify their portfolios at the international level to minimize risk. However, there is high connection between the developed markets for both conventional and Islamic indexes. In addition, for each economy, the Islamic index is found to be strongly linked with its conventional counterpart. The structural change analysis reveals common break dates for several cross correlations, thus reflecting the similar time-paths of the interactions between markets. The presence of breaks in the inter-market

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linkages has important implications for international investors as regards portfolio diversification benefits and for financial policy makers regarding contagion risks and market policies.
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1. Introduction

The literature on Islamic investing explores the particular specificities of the Islamic finance industry, its claimed ethical performance in comparison to the socially responsible investment, and the extent to which the objectives of Islamic law are practically fulfilled by Islamic financial institutions. The Islamic stock prices encompass companies characterized by very weak leverage ratios and interest involvement, which implies that links with regard to information flows and shocks transmission are expected to be effectively severe. In other words, the Islamic financial intermediation mode plays a 'protective' shield role since it alleviates the transmission of shocks and reduces any potential losses due to unexpected financial crises. This may be due to the fact that the asset-backed rule in Islamic finance ensures a close connection between real and financial sectors, which does not affect Islamic financial markets by volatility spillovers from the other markets.

The paper discusses the issue of linkages between conventional and Islamic stock prices from the prism exploring their structural differences from the long- and short-run perspectives in terms of capital and risk allocation, incentive devices of financial contracting, and investment vehicles. The primary aim of this research is to study the dynamics of international assets linkages, and to combine the literature on *Sharia'a*-compliant finance and the literature on standard market integration and portfolio diversification. The paper is appealing for many reasons whose most important is the policy implications to international investors and market participants. Indeed, investors in international financial markets will have the motivation to restructure the perspective of their portfolios by benefiting from diversification of risk seeing the weak correlation and the absence of shocks transmission among Islamic financial markets. The study attempts further to shed some light on these issues by contributing to the limited existing empirical evidence of diversification based on Islamic markets.

Our results show that conventional and Islamic stock markets are linked through long-run relationships for all economies, except for the UK where these markets are not cointegrated. From the correlation analysis, the Indonesian market is found to be weakly correlated with the developed markets for both conventional and Islamic indexes, implying that investors can benefit from diversifying their assets portfolios at the international level. This benefit is judicious for portfolio managers over the short-run only because the long-run cointegration indicates that such benefit vanishes and the Islamic intermediation mode has no distinctive advantage. However, there is high interdependence between the developed stock markets for both conventional and Islamic stock prices. Furthermore, the Islamic stock price of each country is strongly connected to its conventional counterpart. This finding means that portfolio managers cannot benefit from international diversification over the short-run with Islamic markets since the latter do not seem to be compliant to *Sharia'a* maxims for all countries. Indeed, this non-compliance can have several aspects, such as a high correlation between Islamic stock prices and interest rates, trading of real economy products, and a high level of complexity in traded financial instruments. The structural break analysis conducted on the inter-market linkages reveals common change points for several cross correlations, which reflects their similar evolution patterns. These break dates are linked with important international events (e.g., the gradual recovery of world equity markets in 2010, and the uncertainty over the existence of the Euro and the European Union zone), and have important implications for international investors regarding equity portfolio diversification gains and for financial policy makers as regards to contagion risks and market policies.

The rest of the paper is organized as follows. The literature is reviewed in Section 2. Section 3 presents some insights on conventional and Islamic stock markets. The econometric methodology is outlined in Section 4. Data, results and policy implications are discussed in Section 5. Section 6 concludes the paper.

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