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Cross-sectoral interactions in Islamic equity markets ☆

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ABSTRACT

Although it is essential for investors who want to comply with their religious obligations, cross-sectoral interaction in Islamic equity markets is an untouched subject in finance literature. Accordingly, this paper aims to investigate the interactions between the ten major sectors of Islamic equity markets by implementing the novel methodologies of dynamic conditional correlation (DCC) and dynamic equicorrelation (DECO) on Dow Jones Islamic Market sector indexes. We show that prior to the financialization period, firm fundamentals and real economic factors had an important role in driving the Islamic equity prices, however this role seemed to weaken in the last decade with the global financialization, leading to highly integrated Islamic equity sectors just as in the case of the conventional financial sectors. Moreover, this effect is emphasized further through financial contagion channels in the recent global financial crisis. Our findings thus suggest that Islamic equity indexes are also prone to global shocks hitting the world financial system, and investors should be cautious in interpreting and forecasting the interaction structure between Islamic equity sectors. Furthermore, our results do not support the decoupling hypothesis of the Islamic equity markets from the conventional financial system.

1. Introduction

Given the complex and dynamic structure of financial markets, one of the challenges that investors face is the active or passive investing decision. Even though the answer is not certain, the amount of passively managed assets has been gaining momentum for the couple of decades. The popularity of passively managed assets, in turn, promotes the demand on index trading. In fact, Bhattacharya and Galpin (2011)

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showed that the popularity of index portfolio has been increasing globally. Index investors, in general, favor strategic portfolio allocation and are inclined to trade in and out of the markets at the same time. This commonality in market timing results in increased correlation between indexes and consequently decreased diversification benefits. Markets become more synchronized and vulnerable hence the systemic risk level rises. The experience of the 2008 financial crisis showed that, index investors (who link various sectors) sharpen the increase in co-movements between sectors. Within this crises period, in an environment where even the benefits of portfolio diversification have been questioned, market players and academicians started to search for remedies and renovation solutions for the conventional financial system.[1] In this process, Islamic finance emerged as a viable alternative due to its seemingly resilient structure and promising return performance.

In addition to the growing interest from the Western world especially after the 2008 financial crisis, the pace of demand in Islamic finance is growing as a result of the accumulation of pool of oil wealth, strong participation from Muslim investors combined with the keen willingness of regulators to support the development of Islamic markets. Total Islamic finance assets grew to an estimated USD 1.8 trillion by the end of 2013. The industry is estimated to chart a compound annual growth rate (CAGR) of 17.04% between 2009 and 2013. Similarly, the global Islamic funds industry has progressed tremendously; assets under management have grown from USD 29.2 billion in 2004 to more than USD 70 billion as of December 2013. From 2007 to 2012, the total assets managed by Islamic funds increased by a CAGR of 7.3%, while the mature conventional fund industry grew by 1.8% during the same period.[2] According to data compiled by Thomson Reuters Zawya Islamic, USD 85.8 billion of sukuk was sold during the first eight months of 2014.[3] More importantly, four countries (UK, Luxembourg, Hong Kong and South Africa) which do not have a predominantly Muslim population, issued their debut sukuk. These issuances manifest that not only Muslim countries utilized Islamic finance to raise funds.[4] Furthermore, existing markets such as Malaysia, Saudi Arabia, Turkey and the UAE continue their efforts to facilitate growth of Islamic capital markets and flows of funds using Islamic finance instruments.

As the Islamic Law (Shari'ah) compliant products attract more investment, its reflection can be seen from the number of Islamic indexes created. Relatively easy access to Islamic indexes broke the domestic–centric structure of Islamic finance and helped its internationalization. Besides, Islamic fund managers highly benefited from the standardization of Shari'ah screening methodologies[5] of Islamic equity indexes such that the indexes help to reduce research costs, mitigate compliance concerns of Muslim investors and expand the number of securities available to invest. Since the screening methodology has been standardized and sub-indexes have been created, investors have the opportunity to allocate their portfolio in distinctive sectors. Moreover, by investing in passively managed Islamic index funds, Muslim investors do not necessarily need to sacrifice returns to comply with their religious obligations.

Recognition of potential diversification benefits from Islamic finance products and standardization of Shari'ah compliance process for the Islamic indexes stimulated the growth of Islamic finance index investments which, in turn, gave rise to financialization among stocks which are covered by these indexes. Globalization, advances in information dissemination, technological improvements, integration of emerging markets and easy flow of capital between markets precipitated the financialization process. By financialization, we mean the expanded role of financial market developments, risk appetite for financial assets, investment strategies and

[1] "Renovation solutions for the conventional financial system" refers to restructuring of the financial system. As renovation means making changes and repairs so that it is back in "good" condition (not necessarily the same old condition), it is used to refer to the efforts made in financial markets during/after a financial crisis period.

[2] For details, see Islamic Financial Services Industry 2014 stability report at http://www.ifsb.org/docs/2014-05-06_IFSI%20Stability%20Report%202014%20(Final).pdf.

[3] Sukuk is the Arabic name for financial certificates, but commonly refers to the Islamic equivalent of bonds.

[4] For details, see http://www.zawya.com/story/New_sovereign_issues_usher_in_new_era_for_global_sukuk_industry-ZAWYA20140911074237/?zawyaemailmarketing.

[5] To ensure compliance with the Shari'ah rules, Islamic indexes are governed by Shari'ah advisory boards whose role is mainly to review the underlying asset or structure and issue opinions as to their compliance. Stocks are selected by filtering the stock universe through rules regarding business activities and financial ratios. The important point is that the stock universe is not limited by the companies located in Muslim countries. Instead, without considering religious beliefs, indexes include shares from both Muslim or non-Muslim countries provided that they are Sharia-compliant. In fact, as of September 2014, country allocation of Dow Jones Islamic Index to US was 59.08%.