



Islamic investing

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ABSTRACT

Using a large international sample of 35 developed and emerging markets, we analyze whether Islamic indices exhibit a different performance to conventional benchmarks. While there is no compelling evidence of performance differences in robust Sharpe ratio tests and after controlling for market risk, we find a significantly positive four-factor alpha for the aggregate developed markets region. This outperformance stems, however, mainly from the U.S. and is largely attributable to the exclusion of financial stocks in Sharia-screened portfolios. As the extensive downturn of financials is related to the recent financial crisis, we do not argue that this outperformance will continue over time. The style analysis reveals that Islamic indices invest mainly in growth stocks and positive momentum stocks. This, for a passive portfolio intriguing result can, however, be explained by the strong sector allocation towards energy firms and their strong momentum characteristic during the sample period.

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1. Introduction

One of the major innovations in the financial community is the rapid growth of Islamic financial services around the world. Today, Sharia-compliant assets amount to \$939 billion worldwide. While there are more than 600 Islamic funds available, investors have begun shifting their assets from actively managed mutual funds to passive index-based investments.² For investors wanting to allocate capital in accordance with their religious beliefs, it is therefore of interest to know whether a passive portfolio of equities selected by Islamic screening procedures exhibits a different performance than a conventional market portfolio. As there are concerns that a screened portfolio is likely to underperform a conventional (unscreened) portfolio (e.g., Rudd (1981), Grossman and Sharpe (1986)), we pose the questions: Does an Islamic investor have to sacrifice financial performance by investing religiously? Should that be the case, how much is the performance difference? And how does a Sharia-compliant screening process affect the return behavior with regard to common risk factors?

To answer these questions, we investigate in this paper the financial performance and investment behavior of Islamic indices in comparison to conventional market benchmarks in a large international sample encompassing 35 developed and emerging markets around the world using a contemporary measurement framework based on bootstrap simulations and multi-factor models.

Islamic investments must act in accordance with the principles of the Sharia, the Islamic law, governing all aspects of a Muslim's life. Islamic investments are insofar often referred to as Sharia-compliant investments to underscore this circumstance. One of the most distinctive features of Islamic banking and finance is the fact that the payment and receipt of interest is not permitted (Riba). The Sharia encourages instead the use of profit-sharing and partnership schemes. Adherence to these principles is generally conducted by a Sharia supervisory board. A panel of Islamic scholars approves proposed companies and monitors the compliance of their business activities with the guidelines of the Sharia. The following typical screening criteria for Sharia-compliant investments can be summarized:

Inherently, investments in preferred stocks and bonds are unacceptable under the Islamic law, since both promise a fixed rate of return and grant no voting rights (Naughton and Naughton (2000)). Further, companies whose core business involves alcohol, conventional financial services, entertainment, pork-related products, tobacco, or weapons are excluded. In addition, restrictions are applied based on certain financial ratios, meaning companies with unacceptable levels of debt or impure interest income are excluded from the

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² See, Shaping a New Tomorrow: Global Wealth 2011, a report by The Boston Consulting Group, May 2011.

universe of investable stocks. Typically, companies with debt of more than one third of market capitalization are excluded (Hussein and Omran (2005)).

Despite the growing interest in Islamic finance, there are few empirical studies exploring the performance of Islamic investment vehicles. Elfakhani and Hassan (2005) analyze the performance of 46 international Islamic mutual funds from 1997 through 2002 in comparison to a corresponding Islamic market index and a conventional market index. Based on the traditional measures of Sharpe, Treynor, and Jensen, their results suggest that the performance of Sharia-compliant funds and the chosen benchmarks is very similar. Using likewise a traditional performance evaluation framework, Hussein and Omran (2005) examine the performance of the Dow Jones Islamic Market Index (DJIMI) and its 13 sub-indexes (based on size and industry) against their conventional counterparts over the period 1996 to 2003. The authors find that Islamic indexes outperform in bull markets, but underperform in bear markets. Employing Sharpe's (1992) Style Analysis, Forte and Miglietta (2007) examine the asset allocation of the Sharia-compliant FTSE Islamic Europe index as a faith-based investment vehicle in comparison to conventional socially responsible investing (SRI) equity indexes. Finding distinctive differences in style, sector, and country exposure, they conclude that faith-based investments and SRI investments should be addressed as separate investment approaches. Albaity and Ahmad (2008) investigate the performance of the Kuala Lumpur Syariah Index (KLSI) and the Kuala Lumpur Composite Index (KLCI) from 1999 through 2005. Their results provide no evidence of significant statistical differences in risk-adjusted returns between the Sharia-compliant index and the conventional stock market index. Hoepner, Hussain, and Rezac (forthcoming) analyze the financial performance and investment style of 262 Islamic equity funds from twenty countries. The analyzed mutual funds underperform in eight countries, but outperform in three countries. Islamic funds tend to mimic the return behavior of small firms.

Our findings are summarized as follows. While there is no compelling evidence of performance differences between Islamic indices and conventional benchmarks in robust Sharpe ratio tests and after controlling for market risk, we find a significantly positive four-factor alpha for the aggregate developed markets region. This outperformance stems, however, mainly from the U.S. and is largely attributable to the exclusion of financial stocks in Sharia-screened portfolios. As the extensive downturn of financials is related to the recent financial crisis, we do not argue that this outperformance will continue over time. The style analysis reveals that Islamic indices invest mainly in growth stocks and positive momentum stocks. This, for a passive portfolio intriguing result can, however, be explained by the strong sector allocation towards energy firms and their strong momentum characteristic during the sample period.

The remainder of the paper is organized as follows. In Section 2, we describe the international data and present summary statistics. Section 3 outlines the methods and results for performance testing based on the Sharpe ratio. Section 4 examines whether the financial performance of Islamic indices is significantly different from conventional benchmarks using time-series factor regression tests. Section 5 contains additional analyses for robustness concerns, and Section 6 concludes.

2. Data and summary statistics

The data for our study is compiled from four different sources. The return data for the Islamic indices and conventional benchmarks are obtained from Morgan Stanley Capital International (MSCI). In general, we study monthly total returns (so-called gross returns with reinvested dividends), except for the Value at Risk (VaR) measure, where we employ daily total returns for its computation. There are in total 44 Islamic country indices (23 from developed markets and 21 from

emerging markets) available from MSCI. However, we have to exclude nine markets from our analysis because of data issues. Hungary, Ireland, and Portugal due to non-continuous time-series return data from MSCI. Colombia, Czech Republic, Egypt, Morocco, Poland, and Russia on account of low firm coverage in Datastream/Worldscope disallowing us to form adequate explanatory factors (i.e., SMB, HML, and WML) for these markets over the complete sample period. Thus, our final data set leaves use with 35 investigable single markets (21 from developed markets and 14 from emerging markets). In addition, we include in our analysis the aggregate (multi-country) indices of the developed and emerging markets regions as highly diversified portfolios.

The explanatory factors for the United States are from Kenneth French's data library.³ As Griffin (2002) and Fama and French (2011) show that capital markets do not seem to be integrated suggesting that size, value, and momentum factors are country-specific, we form respective factor portfolios for the other markets in our sample. For the construction of non-U.S. explanatory factors, we use total return data on common stocks from Datastream to form respective zero-investment, factor-mimicking portfolios for size, book-to-market equity, and momentum in each market. All accounting data (e.g., the book value of common equity) for the construction of non-U.S. explanatory factors is obtained from Worldscope. Firms must have a positive book value to be included in the sample and as common in the asset pricing literature, we exclude financial firms with Standard Industrial Classification (SIC) codes between 6000 and 6999 in the factor portfolios. To ensure the quality of our data, we apply the screening procedures proposed by Ince and Porter (2006). All data is denominated in U.S. dollars and the risk-free rate is calculated using the one-month U.S. Treasury bill rate. The sample period is June 2002 to June 2011 (109 months).

Table 1 provides summary statistics for our set of Islamic indices and their conventional benchmarks. Panel A and B describe the single markets and Panel C the aggregate markets. The average annualized Islamic index returns in developed market countries (Panel A) range from 4.2% to 22.4%, while the conventional benchmarks produce average returns from 4.5% to 19.8% per year. The average index returns in emerging markets (Panel B) are considerably higher compared to developed markets. They vary for the Islamic indices between 11.3% and 32.5% per year and from 10.5% to 32.3% per year for the conventional benchmarks. Thus, indicating a largely similar return spectrum between the two index variants in the emerging markets countries over the sample period. This is confirmed by the statistics of the aggregate (multi-country) indices in Panel C. While the Islamic index outperforms the conventional benchmark by 1.5% per year in developed markets, the average annualized index return is not distinguishable from its conventional benchmark in emerging markets.

Fig. 1 illustrates the growth of the index values of the Islamic indices in comparison to the conventional benchmarks over the sample period along with the year-by-year returns for the aggregate developed (Panel A) and emerging (Panel B) markets regions. While the growth of the two index variants is largely similar in emerging markets, the developed markets Islamic index outpaces the conventional benchmark as of 2007 with the beginning of the recent financial crisis and the extensive downturn of bank and financial services stocks. We will discuss this issue in more detail in the robustness section.

The annualized standard deviations of monthly returns in Table 1 tend to be smaller for the Islamic indices of developed markets, while they seem to be higher in emerging markets respectively relative to the conventional benchmarks. However, it is obvious that the higher average returns of emerging markets indices are accompanied by higher levels of volatility.

³ The data library is accessible through: <http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/>.

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