Strategies for ISLAMIC FINANCE

Bangor Business School's M Iqbal Asaria examines whether investing in a stock universe screened for sharia law will deliver an inferior return.

The Islamic banking and finance industry has grown rapidly over the past 30 years and currently boasts over $1 trillion dollars of assets.

This growth has been accompanied by demands for robust asset management tools within the scope of sharia, the Islamic law. The key requirement is access to all relevant asset classes to enable Islamic asset managers to deliver like-for-like risk-return adjusted outcomes to that already achieved by their conventional counterparts.

Much progress has been made in developing all asset classes within the framework of the sharia over the past three decades. For example, the concept of "sukuks" has been introduced, equivalent to the "bond" class for secure and liquid investments. Appropriate structures have been developed too for investment in real estate. Progress has also been made in developing a number of alternative asset classes, including private equity and a limited range of derivatives for currency hedging requirements.

The development of models for investment in equities, within the parameters of sharia law, presents a number of challenges. Like those working in ethical or socially responsible investments (SRIs), or environmental, sustainability and governance-oriented funds (ESG), full screening of all the potential investments in the "stock universe" is required.

This includes screening the constituents of any potential investment for compliance with sharia criteria. These criteria mainly relate to restricting investment in a number of activities, such as companies involved in alcohol, tobacco, gambling or arms manufacturing. Similarly, investments in companies providing interest-based services are also screened out. This set of criteria rules out most banks, insurance companies and other financial institutions.

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Furthermore, based on the sharia's abhorrence of "usury" (unethical lending), companies with gearing levels of over a third are screened out. This is one of the key distinguishing features of sharia-screened portfolios compared to other faith, ethical, SRI and ESG counterparts.

Finally, any companies having more than 5 per cent of their revenues derived from non-permissible activities are also excluded from investment by the Islamic banking and finance industry.

The resultant universe of investible stocks, therefore, is much smaller than that available to conventional fund managers. Typically, the sharia-screened universe is less than a third of that available to fund managers. Therefore Islamic fund managers have a formidable challenge in delivering comparable investment returns.

Studies reveal that over the past decade, Islamic asset managers have not suffered

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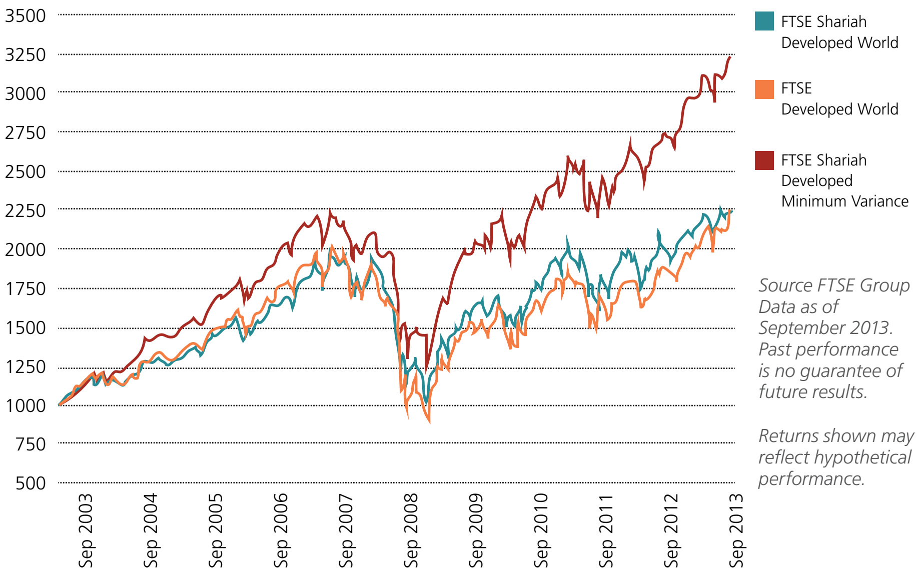
from a sharia “penalty” due to a smaller investible universe and can still deliver adequate performance.[1]

As the need for Islamic fund management increases, more consistent strategies to allow for comparable performance with conventional fund management is required. The FTSE has already investigated investment in sharia-screened minimum variance portfolios to see if the restrictions on leverage in Islamic portfolios can be utilised to their best advantage. Early results are encouraging and tend to show enhanced performance over that achieved by standard sharia-screened portfolios. A full research paper detailing the findings can be viewed on the FTSE website.[2]

If the results stand the test of time, minimum variance sharia-screened portfolios can attract many more fund managers who have requirements to invest in accordance with the rules of the sharia. This may include several sovereign wealth funds exploring sharia-complainant investment strategies in response to demands from their respective constituencies.

FTSE Shariah Minimum Variance and Developed World performance



Source FTSE Group Data as of September 2013. Past performance is no guarantee of future results.

Returns shown may reflect hypothetical performance.

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[1]*Kamso, Noripah: Investing in Islamic Funds – A Practitioner’s Perspective, 2013, John Wiley & Sons*

[2]*FTSE sharia Research: Targetting Lower Volatility Through Ethical and Quantitative Screening. Minimum Volatility sharia Index, FTSE September 2013, Available at: http://www.ftse.co.uk/Research_and_Publications/2014Downloads/FTSE_sharia_Research.pdf*