

# INTERNATIONAL JOURNAL OF RESEARCH IN COMMERCE & MANAGEMENT

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of  
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in  
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**STATEMENT OF THE PROBLEM**

**OBJECTIVES**

**HYPOTHESES**

**RESEARCH METHODOLOGY**

**RESULTS & DISCUSSION**

**FINDINGS**

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# ETHICAL INVESTING ON THE STOCK MARKET: SHARI'AH-COMPLIANT INDEXES – A DYNAMIC INVESTMENT MECHANISM

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**MUMBAI**

## ABSTRACT

Investing activities that adheres to Islamic restrictions of not investing in socially harmful businesses is known as Islamic investments. Islam also puts a check on human behavior and manners that are harmful for society such as gambling, short-selling, cheating etc. It should be noted that there is nothing 'Islamic' about Shari'ah compliant indexes, as most of the underlying companies are not from the Muslim countries. These compliant companies just happen to pass primary business screens (akin to social-ethical indexes) and financial screens (eliminates companies with high debt, high account receivable translating sales into earnings, and too much non-operating interest income). Today Shari'ah compliant indexes are operating in seventy four countries around the world including India, of these only thirteen countries are Islamic countries. In most of the cases in comparison to conventional indexes they outperform. In India the BSE in late 2010, launched the BSE Shari'ah Index and subsequently NSE too, has its Shari'ah Index, the S&P CNX Nifty Shari'ah.

JEL COLDE

G1: General Financial Markets

## KEYWORDS

Indexes; Islamic; Shari'ah; Sukuk; Takaful.

## INTRODUCTION

The US financial system is the main engine that drives the entire global economy. Obviously, if the prime engine breakdowns, it will show a negative impact on others. Despite many measure taken by the RBI and government of India, the fact remains that India, like the rest of the Asia, is very much linked to the health of the American financial system. Capital flows in the Indian stock market under FII depend on the easy liquidity in the American financial system. The catastrophic global shockwaves from the US blocked the liquidity so that world stock markets witnessed a massive disaster of stock markets in Asia and Europe.

On the other hand during the crisis period the stocks and stock indices which adhered to the Shari'ah Compliant Investment Principles were safer and resisted the onslaught.

This paper introduced the basic concepts of Shari'ah Compliant Investment Principles which can be guiding principles for future investments for both the individuals and the financial institutions.

## OBJECTIVES

Majority of the individual investor on the stock market are unaware of better options available to invest on the same stock market. This paper is an attempt to:

- Create awareness about Shari'ah Complaint Index investment opportunities.
- Highlighting the ethical advantages of Shari'ah Complaint investments.
- Identifying the Shari'ah Complaint Index in India.

## RESEARCH METHODOLOGY

Desk Research Technique has been adopted for this paper,

Data has been collected from various sources like books, magazines, journals etc. both offline and online.

## LIMITATIONS

The area of study is very vast. Here only limited reference is taken and the analysis done is basic. There is ample scope for further detail in-depth analysis.

## ISLAMIC INVESTMENTS OR SHARI'AH COMPLIANT INVESTMENT

Investing activities that adheres to Islamic restrictions of not investing in socially harmful businesses is known as Islamic investments. Islam also puts a check on human behavior and manners that are harmful for society such as gambling, short-selling, cheating etc.

## ISLAMIC NORMS OF INVESTMENTS

- Business activities must be beneficial to the society, economy and environment;
- Non-serious traders must stay away from the market;
- Traders/investors should not participate in Short-selling, gambling, risk trading and any kind of interest-based activities;
- Check on debt and earnings from impure sources; and
- Increased Charity and public welfare activities;

## DIFFERENCE BETWEEN SHARI'AH V/S CONVENTIONAL INVESTMENT IN STOCK

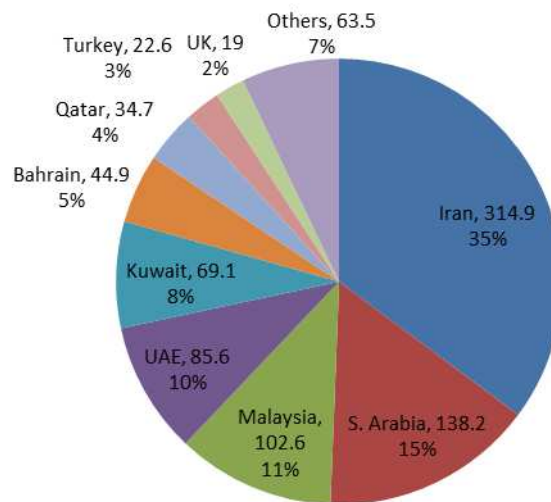
TABLE 1

Shari'ah Investments	Conventional Investments
Hedging using derivatives not allowed	Hedging is allowed
Cash settled futures is prohibited	Cash settled in future is allowed
Investment in banks, insurance and any company conducting non-Shari'ah business is not allowed	Investment in banks, insurance companies, etc. is allowed
Investment can't be made in Interest bearing instruments & securities. Free cash to be kept in current account therefore returns could be affected	Investment can be made in bonds, CP, CD, and other interest bearing instruments to reduce volatility
Shari'ah Audit to confirm that Shari'ah principles are followed in making investments.	No special audit
Copy of Shari'ah Compliant Audit provided to investors.	No specific compliance audit provided to investors

## THE GROWTH OF ISLAMIC FINANCE

Islamic Finance has been on the increase over the years. It includes Islamic banking, Sukuk (Islamic Bonds), Takaful (Islamic Insurance) and Islamic fund assets. The tables and charts below are self-explanatory.

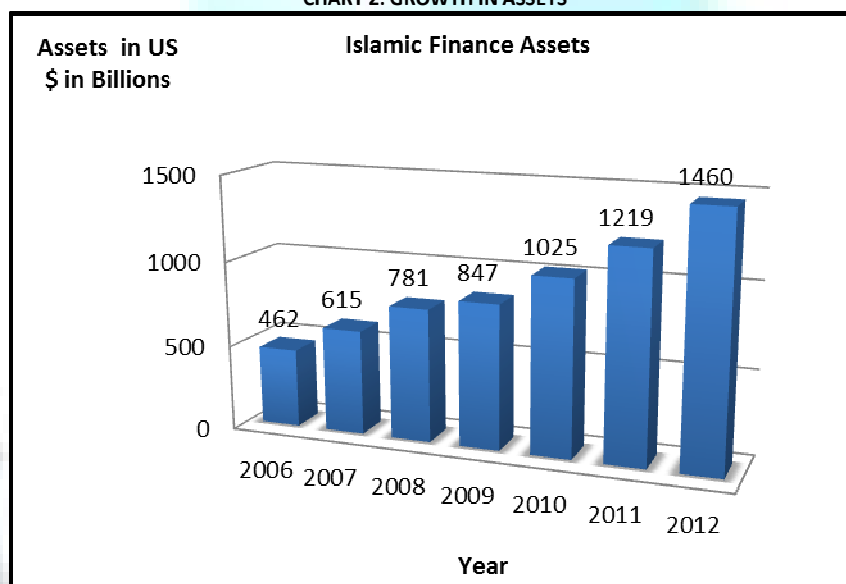
**CHART 1: COUNTRY WISE BANKING, TAKAFUL & FUND ASSETS IN US \$ IN BILLION & PERCENTAGE AT THE END OF 2009**



**TABLE 2: COMPOSITION OF ISLAMIC FINANCIAL ASSETS (US\$ Billion, 2012 E)**

Countries/Blocs	Banking Assets	Sukuk Outstanding	Islamic Funds Assets	Takaful Contributions
Asia	171.8	160.3	22.6	2.7
Gulf Cooperation Council (GCC)	434.5	66.3	28.9	7.2
Middle East & North Africa (MENA) (exc. GCC)	550.6	1.7	0.2	6.9
Sub-Sahara Africa	16.9	0.1	1.6	0.4
Others	59.8	1.0	10.8	00
<b>Total</b>	<b>1273.6</b>	<b>229.4</b>	<b>64.2</b>	<b>17.2</b>

**CHART 2: GROWTH IN ASSETS**



Source: The Charts and table created by the author with the data procured from, The Banker, Ernst & Young & thecityuk

## INTERNATIONAL SCENARIO

### SHARI'AH-COMPLIANT INDEXES<sup>1</sup>

The year 2011 was the year for Shari'ah compliant index out-performance against all conventional developed and emerging market country indices and almost all frontier countries.

Looking at Shari'ah compliant indexes, it should be noted that the 'Islamic' tag about Shari'ah compliant indexes has nothing to be repulsive about with reference to Islam. Most of the underlying companies are not from the Muslim countries and majority of the investors are from various religion. These compliant companies just happen to pass primary business screens (akin to social-ethical indexes) and financial screens (eliminate companies with high debt, high account receivable (translating sales into earnings, and too much non-operating interest income).

May be such screening is the need of the hour for all investors during external shocks or financial tsunamis of sub-prime credit crisis, sovereign debt crisis, so on. Shari'ah Compliant Indexes adhere to it.

**SHARI'AH-COMPLIANT INDEX DESIGN<sup>2</sup>**

Shari'ah-compliant indexes can be differentiated from their conventional counterparts in three main ways. Shari'ah supervisory boards establish inevitability guidelines and monitor the process; then the guidelines are applied to the universe of securities; and finally, purification rules are set to "cleanse" any impure profits from securities-paying dividends.

The first step in the screening process is to exclude companies that are active in prohibited industries. This includes companies that are involved in hospitality and gaming, alcohol, pork, pornography, many media companies, as well as conventional financial services institutions and insurance.

Companies passing the first screen are then sifted through a second screen consisting of financial ratios. For the Dow Jones Islamic Market Index family, exclusions are applied to companies with:

- more than 33% total debt divided by a 24-month average market capitalisation;
- more than 33% cash and interest-bearing securities divided by a trailing 24-month average market capitalisation; and
- accounts receivable more than 33%.

Regular qualitative scrutiny is particularly relevant when it comes to company debt. To take one example, a company's stock may have a portion of non-Shari'ah-compliant debt, which is not apparent from information contained in publicly released financial statements.

A debt-to-market capitalisation ratio better captures the "new economy" economies, service-orientated companies, or companies that rely on larger amounts of goodwill. This is also more dynamic, as it captures market-sector rotations. Because debt-to-market capitalisation is market value based, it is less subject to manipulations than debt-to-market assets, which are an accounting treatment.

Thanks to this methodology, it is also easier to measure the health of the companies included in the index. For instance, companies like Enron, WorldCom, Tyco, and Global Crossing were all in the Dow Jones Islamic Market Index, but as their accounting issues emerged into the public domain, their market capitalizations were negatively impacted. Since they violated the debt-to-market-cap screen, they were removed from the indexes at the next quarterly review, before they had bigger problems.

**COMPARISON BETWEEN CONVENTIONAL AND SHARI'AH OF DEVELOPED COUNTRIES INDICES****TABLE 3: DEVELOPED COUNTRIES INDICES**

Sr. No.	Country	Conventional	Shari'ah
1	Austria	-36.98%	-27.55%
2	Australia	-13.40%	-22.97%
3	Belgium	-16.96%	-16.02%
4	Canada	-14.59%	-19.67%
5	Switzerland	-9.41%	-3.04%
6	Germany	-23.12%	-15.21%
7	Denmark	-19.46%	-10.10%
8	Spain	-16.77%	2.31%
9	Finland	-35.38%	-28.35%
10	France	-23.69%	-5.61%
11	Greece	-62.77%	-29.84%
12	Hong Kong	-21.26%	-19.84%
13	Ireland	-3.25%	4.43%
14	Israel	-29.74%	-24.69%
15	Italy	-27.61%	-21.29%
16	Japan	-14.43%	-11.24%
17	Korea	-10.90%	-7.47%
18	Luxembourg	-34.45%	-1.36%
19	Netherlands	-16.42%	-9.97%
20	Norway	-18.06%	-14.92%
21	New Zealand	-3.85%	-3.60%
22	Sweden	-18.52%	-17.71%
23	Singapore	-21.15%	-11.46%
24	United Kingdom	-6.67%	-3.45%
25	United States	-0.82%	1.60%
26	Portugal	-30.96%	NA

**SOME OBSERVATIONS FROM THE S&P DEVELOPED COUNTRY INDICES FOR 2011**

- Shari'ah compliant indices out-performed conventional counterpart indices in 23 of the 25 developed countries, excluding Portugal (no Shari'ah index)
- Shari'ah compliant indices out-performed conventional counterpart indices in all the major countries encountering turmoil in 2011: US (positive return), Greece, Spain (positive return), Ireland (positive return), Italy, etc. There were not enough compliant companies for a Portugal Shari'ah compliant index.
- Shari'ah compliant indices out-performed conventional counter-part in Germany and France, two countries with large exposure to sovereign debt crisis in Europe
- Shari'ah complaint indices under-performance in resource plays of Australia and Canada yet out-performed in technology (IT) heavy Shari'ah compliant Israel Index.

**COMPARISON BETWEEN CONVENTIONAL AND SHARI'AH OF EMERGING MARKET COUNTRY INDICES****TABLE 4: S&P EMERGING MARKET COUNTRY INDICES FOR 2011**

	Emerging Markets	Conventional	Shari'ah
1	South Africa	-17.42%	-17.66%
2	Brazil	-24.41%	-29.56%
3	China	-21.67%	-13.81%
4	Colombia	-12.00%	-8.67%
5	Czech Republic	-15.02%	-2.41%
6	Chile	-24.14%	-22.19%
7	Egypt	-49.14%	-42.66%
8	Hungary	-35.29%	-30.46%
9	Indonesia	1.14%	-12.71%
10	India	-38.05%	-32.84%
11	Morocco	-17.72%	-23.21%
12	Mexico	-14.84%	-22.08%
13	Malaysia	-1.14%	3.81%
14	Peru	-21.31%	-25.20%
15	Philippines	0.22%	8.29%
16	Poland	-33.35%	-21.14%
17	Russia	-23.38%	-18.80%
18	Thailand	-4.73%	14.44%
19	Turkey	-37.01%	-29.55%
20	Taiwan	-25.58%	-23.08%

**Some observations from the S&P Emerging Market Country indices for 2011**

- Shari'ah compliant emerging market country indices outperformed conventional counter-part indexes in 14 of the 20 countries.
- Shari'ah compliant Muslim country indices outperformed (Turkey, Malaysia, Egypt) conventional in 3 of the 5 (Morocco and Indonesia) emerging market countries
- Shari'ah compliant indices from the BRIC countries out-performed in three (Russia, India and China) of four (Brazil) countries.
- Shari'ah compliant indices from SAMI countries out-performed in three (Turkey (Ankara), Malaysia, and Saudi (classified as frontier country) of the four (Indonesia) countries.
- Shari'ah compliant indices had positive return in three countries, Thailand, Malaysia and Philippines, whereas conventional had positive return for only one country, Philippines.

**COMPARISON BETWEEN CONVENTIONAL AND SHARI'AH OF FRONTIER MARKET COUNTRY INDICES****TABLE 5: FRONTIER MARKETS (Courtesy: S&P)**

Sr. No.	Frontier Markets	Conventional	Shari'ah
1	Argentina	-30.22%	-28.02%
2	Bangladesh	-42.31%	-45.56%
3	Bulgaria	-22.10%	-16.61%
4	Croatia	-30.34%	-20.68%
5	Coted'voire	-15.15%	-16.33%
6	Kenya	-31.63%	-38.83%
7	Kazakhstan	-36.40%	NA
8	Lebanon	-22.21%	-19.76%
9	Lithuania	-16.14%	-20.12%
10	Mauritius	-2.51%	20.72%
11	Romania	-18.16%	-27.39%
12	Slovakia	3.05%	-4.54%
13	Slovenia	-30.74%	-19.02%
14	Tunisia	-13.43%	-17.30%
15	Ukraine	-36.29%	-25.62%
16	Vietnam	-26.82%	-6.86%
17	Zambia	-1.29%	4.21%
18	Jordan	-16.24%	-7.69%
19	Sri Lanka	-23.04%	-8.18%
20	Nigeria	-29.54%	-17.16%
21	Pakistan	-18.80%	-14.04%
22	United Arab Emirates	-16.48%	-30.42%
23	Bahrain	-14.37%	-31.60%
24	Kuwait	-21.36%	-26.58%
25	Oman	-14.09%	-9.80%
26	Qatar	3.34%	3.59%
27	Saudi Arabia	-3.90%	-1.69%

**SOME OBSERVATIONS FROM THE S&P FRONTIER COUNTRY INDICES FOR 2011**

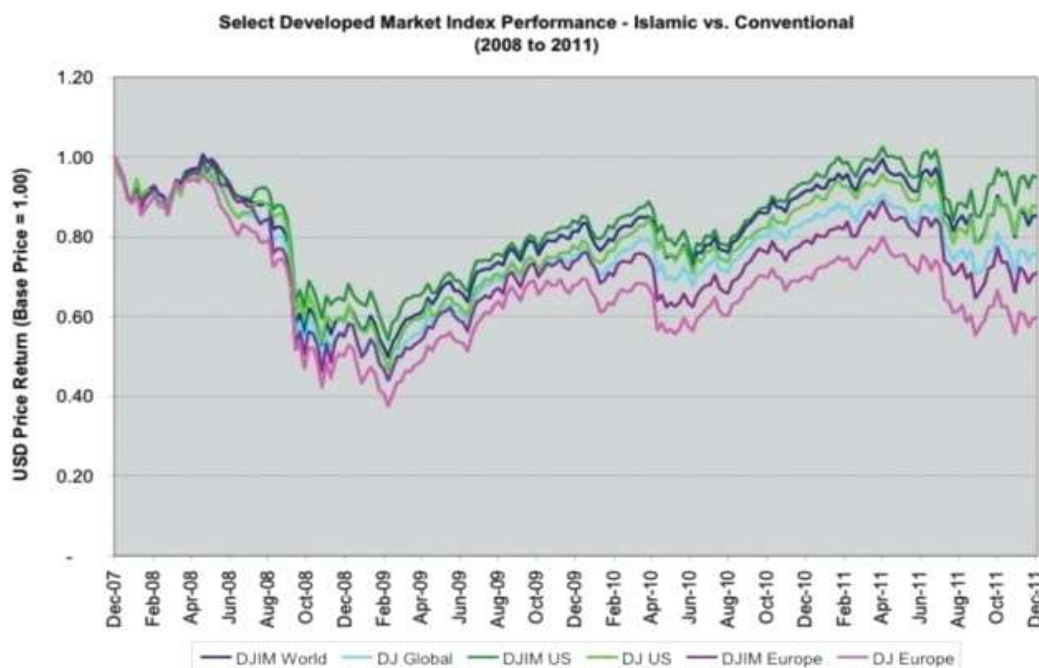
- Shari'ah compliant indices out-performed in 16 of the 26 frontier countries. It should be noted that 11 of the countries, including Kazakhstan, did not have a Shari'ah compliant country due lack of enough companies for an index. Kazakhstan stands out because it has made statements of wanting to be an Islamic finance hub.
- Shari'ah compliant indices from the Muslim countries outperformed better than conventional country indices in 7 of the 13, ex Kazakhstan, countries. It should be noted most of the Muslim countries are classified as frontier countries except five countries: Turkey, Malaysia, Morocco, Indonesia and Egypt.

It should be noted the S&P Malaysia Shari'ah BMI (+3.8%), ahead of S&P Qatar Shari'ah (+3.5%), was the best performing Shari'ah compliant index from the 18 Muslim countries covered by S&P. Although, the S&P Malaysia BMI conventional index (at -1.14%) underperformed the Shari'ah compliant index, it was the second best performing in the Muslim world behind S&P Qatar (+3.34%).

The S&P Malaysia Shari'ah BMI (at +3.8%) outperformed all conventional developed and emerging market S&P country indexes, and only underperformed three conventional country frontier countries: Jamaica (+28%), Panama (+18%), and Namibia (+6%).

## PERFORMANCE: SHARI'AH-COMPLIANT INDEXES VS. CONVENTIONAL INDEXES

CHART 3

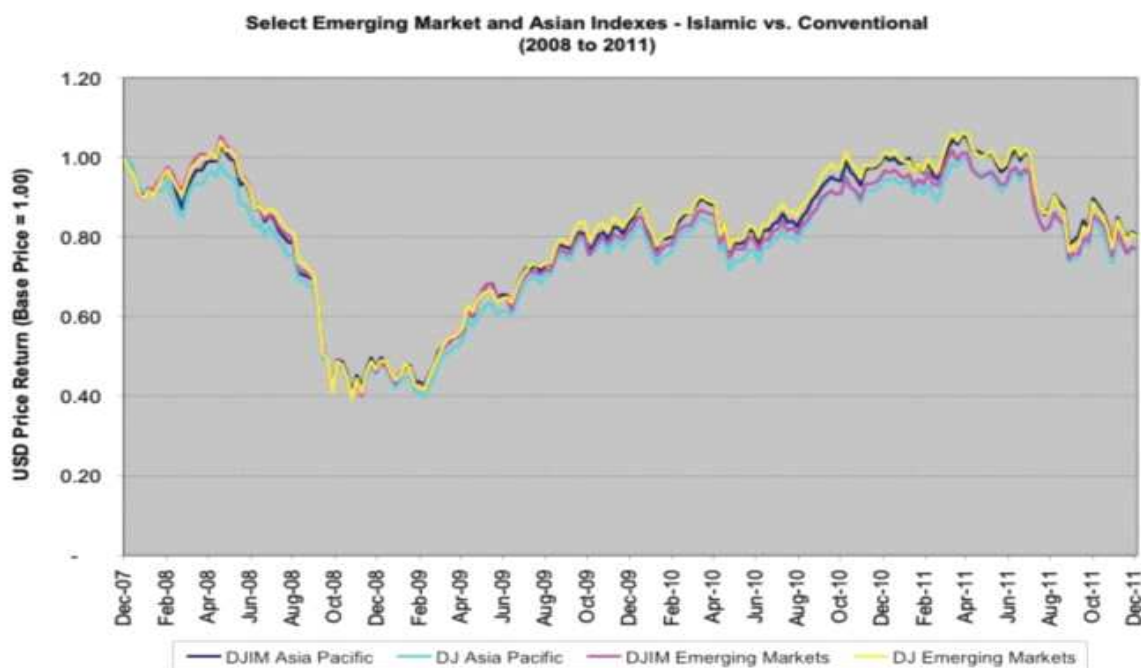


Source: businessislamica.com

When Dow Jones Indexes launched the Islamic index family in 1999, it was challenging to assess the indexes' performance. It was clearly a niche market with growing demand, but no one would have guessed that Islamic indexes would outperform conventional indexes.

The figure above indicates that the DJIM World index has outperformed the Dow Jones (DJ) Global Index by a significant margin. A similar situation prevailed with the DJIM US versus the DJ US and the DJIM Europe versus the DJ Europe.

CHART 4



Source: businessislamica.com

When compared to other markets and regions, the Islamic indexes still outperform conventional indexes (see figure above), but not in all cases. In Asia and the emerging markets, there was a lesser gap between the performance of Islamic and conventional indexes. According to Figure 2, the DJIM Asia Pacific Index outperformed the DJ Asia Pacific Index; however, the DJ Emerging Markets Index outperformed the DJIM Emerging Markets Index. This is due to two main factors: first, Shari'ah-compliant screens remove all highly leveraged companies, which tend to be more volatile — they increase faster in bull markets and fall

faster in bear markets. Secondly, Shari'ah-compliant screens tend to result in indexes that are overweight in certain industries — such as healthcare, technology, oil & gas — while, at the same time, are underweight in such sectors as financial services, insurance, entertainment, media and hospitality.

### TRENDS AND OUTLOOK FOR 2014

Islamic indexes have provided much needed transparency, which is crucial in a post-financial crisis world. Retail investors particularly put their trust in index providers and expect them to have completed due diligence on their behalf.

Two important developments during these years has been first the development of Shari'ah-compliant exchange-traded funds (ETFs), which is in operation in fifteen countries and the listing of Islamic funds in key fund domiciles. Asset managers continue to flock to these market — some estimates suggest that there are about 500 Islamic product providers worldwide.

### INDIAN SCENARIO

In late 2010, it launched the BSE Shari'ah Index. Shari'ah, the religious law of Muslims, has strictures relating to finance and commerce — to be abided by the faithful. Arab investors invest in 'clean' stocks only. The National Stock Exchange (NSE), too, has its Shari'ah index — S&P CNX Nifty Shari'ah.

The indices shun companies that disregard their 'faith'. Internationally, there are many such indices built on various themes. Examples include S&P's Global Luxury and Global Water Index and FTSE's Good Index. There are a number of thematic and strategic indices on the Dow Jones. The MSCI, too, has theme-based indices. These indices invest across sectors, providing you with ample diversification.

Take a look at the BSE's Shari'ah Index — it has 50 stocks of companies that do not deal in alcohol, conventional financial services (banking and insurance), entertainment (cinemas and hotels), tobacco, pork, defence and weapons. TCS is the biggest stock in the index, with 8.26 per cent allocation (ONGC, RIL, Bharti Airtel and HUL follow). The index has risen 3.13 per cent in one month and 5.2 per cent in a year. In contrast, the Sensex was up 2.89 per cent in the last month and down slightly by 0.51 per cent in a year.

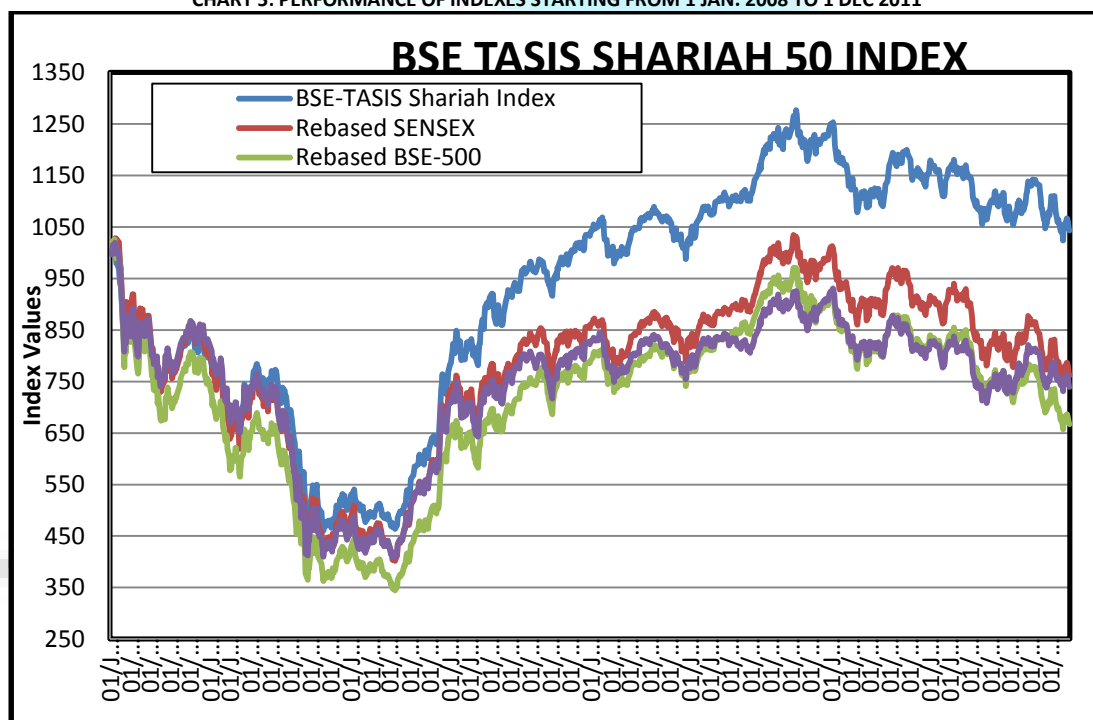
TABLE 6: THEME INDEX

INDEX	1-Month Return (%)	1-Year Return (%)
SENSEX	2.88	-0.52
BSE Greenex	3.06	0.17
BSE TASI Shari'ah 50	3.20	5.27
MSCI World Islamic Index	3.49	-2.96
MSCI USA Catholic Values Index	3.92	4.08
S&P Global Luxury Index	6.27	12.24
S&P Global Water Index	4.16	-0.06
FTSE4 Global Good Index	4.55	-5.49

Source: Compiled by B S Research Bureau

Retail investors have to be extra-vigilant when it comes to investing directly in stocks. Do the usual background check for investments — such as looking at the fundamentals of the company, its valuations, and the stock price performance.

CHART 5: PERFORMANCE OF INDEXES STARTING FROM 1 JAN. 2008 TO 1 DEC 2011



Source: shariqnisar.com

### CONCLUSION

One challenging and volatile year (2011) does not establish a performance pattern for Shari'ah compliant indexes that are 'light' on exposure to the conventional financial sector, typically the largest market capitalization weighted in almost all countries. However, it shows that 'low-debt, non-financial-social/ethical' way of investing does well when there was an external shock to the financial/capital markets.

In today's evolving market, Islamic finance has developed a solid track record and, as a result, will continue to be a dynamic and evolving industry. Index providers, both the larger and the regional, will continue to evolve and stay on top of these developments. The current market presents exciting prospects for the industry as conventional finance begins to look more closely at Islamic finance to see what lessons could be learnt from it. Time will tell if conventional finance develops some of the core principles of Islamic finance.

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**NOTES**

1. Rushdi Siddiqui, Global Head of Islamic Finance, Thomson Reuters
2. Tariq Al-Rifai, Director, Islamic Market Indexes, Dow Jones Indexes

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**WEBSITES**

6. [www.businessislamica.com](http://www.businessislamica.com)
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