COMPARATIVE PERFORMANCE BETWEEN ISLAMIC AND CONVENTIONAL EQUITY FUNDS IN MALAYSIA

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ABSTRAK

Tesis ini mengkaji hubungan antara dana ekuiti Islamik dan dana ekuiti konvensional bagi tempoh Januari 2011 hingga Oktober 2015. Kajian ini dijalankan untuk menyiasat samada prestasi kedua-dua unit amanah ini dapat mencapai prestasi yang lebih tinggi berbanding penanda aras pasaran. Indeks Shariah Emas Bursa Malaysia (FBMEMAS) dijadikan sebagai penanda aras pasaran bagi dana ekuiti Islamik dan Indeks Komposit Bursa Malaysia Kuala Lumpur (FBMKLCI) dijadikan sebagai penanda aras pasaran bagi dana ekuiti konvensional. Sebanyak lapan belas sampel keseluruhan bagi dana ekuiti Islamik dan tiga puluh dua dana ekuiti konvensional dikaji dengan menggunakan tiga prestasi pengukur iaitu indeks Treynor, Sharpe dan Jensen. Nilai mingguan bagi Nilai Aset Bersih untuk dana ekuiti Islamik dan dana ekuiti konvensional diperoleh dari pangkalan data Bloomberg.

Keputusan menunjukkan bahawa keuntungan purata dana ekuiti konvensional adalah lebih tinggi berbanding dana ekuiti Islamik. Walau bagaimanapun, apabila perbandingan kepada penanda aras pasaran dibuat, dana ekuiti Islamik menunjukkan pulangan yang lebih tinggi daripada penanda aras pasaran Indeks Shariah manakala dana ekuiti konvensional menunjukkan prestasi pulangan rendah daripada penanda aras pasaran Indeks Komposit. Dana ekuiti konvensional juga memiliki risiko sisihan piawai yang lebih tinggi berbanding dana ekuiti Islamik yang menunjukkan dana ekuiti konvensional adalah lebih berisiko daripada dana ekuiti Islamik. Tambahan, analisa risiko pasaran menunjukkan dana ekuiti Islamik mempunyai nilai beta yang rendah berbanding dana ekuiti konvensional dan ini menunjukkan dana ekuiti Islamik kurang sensitif kepada perubahan pasaran. Tesis ini boleh dikaji dangan lebih mendalam menggunakan sampel yang lebih banyak dan ciri-ciri yang lain manakala prestasi boleh diukur dengan menggunakan prestasi pengukur selain prestasi pengukur indeks, Sharpe, Treynor dan Jensen.

Katakunci: Unit Amanah, Dana Ekuiti Islamik, Dana Ekuiti Konvensional

ABSTRACT

This study examines the relationship between Islamic and conventional equity funds for the period of January 2011 to December 2015. The performances of both types of funds are then compared to the market benchmark to determine whether they outperformed their respective market benchmark. The FTSE Bursa Malaysia EMAS Index (FBMEMAS) is used as the market benchmark for Islamic equity funds and FTSE Bursa Malaysia index (FBMKLCI) is used as the market benchmark for conventional equity funds. A total of 18 Islamic equity funds and 32 conventional equity funds are evaluated by using three performance measures namely Treynor index, Sharpe index and Jensen alpha. The weekly Net Asset Value (NAV) of the Islamic and conventional equity funds, the market benchmark of FBMEMAS and FBMKLCI were obtained from the Bloomberg database.

The results indicate that the average returns of conventional equity funds are higher than the Islamic equity funds. Nevertheless, when compared against their respective benchmark, Islamic equity funds performed better than its Shariah benchmark while conventional underperform its composite benchmark. Conventional equity funds also have higher standard deviation than Islamic equity funds which implied that conventional equity funds are more risky than Islamic equity funds. Additionally, systematic risk analysis shows that Islamic equity funds have lower beta value than conventional equity funds; hence it shows that Islamic equity funds are less sensitive to the changes in the market. This study could be further investigated in a bigger sample and characteristics while performance can be measured using other technique than Sharpe index, Treynor index and Jensen alpha.

Keywords: Unit Trust, Islamic Equity Fund, Conventional Equity Fund

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CHAPTER 1
INTRODUCTION

1.1 Background of the Study

A unit trust fund is an investment fund that is competently managed by a fund manager, which accumulates the capitals from single investors or institutional investors with similar investment objectives. The funds are long-term investment products, which matched to individual investors who want potential long-term capital growth and are capable to bear the short-term's prices volatility. With the large sum of capital, the fund administrator will invest in a variety of assets such spreading the capital into equity market, money market, fixed income, properties or others according to the investment objectives of the fund, which may not be accessible to an individual investor. [1]Direct investments in specific asset class require quite a huge sum of capital that normally outside the affordability of an individual. But as a group, these categories of investments can become available to them; in which the average, a preliminary investment in unit trusts can begin from as little as RM500[2]. The nature of the fund, the investment strategy and the objectives will be the basis for the fund's portfolio type. For example, an equity fund offers the depositors with availability to the equity market and a possibly earn capital gain and dividend income.

The first asset management company in Malaysia called the Malayan Unit Trust Ltd. was introduced by a number of Australian investors in 1959. Throughout the year of 1959 -1979s, this industry was categorised as a slow growing in unit's trades and a lack of public awareness of the new investment vehicles. Over the period, there were

[1] https://en.wikipedia.org/wiki/Unit_trust
[2] www.maybank2u.com.my (Investment Guide: Unit trusts)

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APPENDICES

FAQS

Frequently-Asked Questions on Revised Shariah Screening Methodology

1. Why has the Securities Commission Malaysia's (SC) Shariah Advisory Council (SAC) revised the Shariah screening methodology for companies listed and to be listed on Bursa Malaysia?

In 1995, the SC's SAC established the methodology to undertake Shariah screening process for listed companies. The methodology comprises quantitative and qualitative assessments.In view of the current development and sophistication of the Islamic finance industry, the screening methodology has now been revised by adopting a two-tier approach to the quantitative assessment which applies the business activity benchmarks and the newly-introduced financial ratio benchmarks while at the same time maintaining the qualitative assessment.This revision is in line with the SC's initiatives to further build scale in the Shariah-compliant equity and investment management segments as well as expand the Islamic capital market's (ICM) international reach, as outlined in the Capital Market Masterplan 2.

2. What are the changes in the Shariah screening methodology?

The changes are as follows:

Quantitative Assessment	Revised Shariah Screening Methodology	Current Shariah Screening Methodology
Business activity benchmarks	5% 20%	5% 10% 20% 25%
Financial ratio benchmarks	33%	Not Applicable

Business Activity Benchmarks

The 5% benchmark would be applicable to the following business activities:

conventional banking;

conventional insurance;

gambling;

liquor and liquor-related activities;

pork and pork-related activities;
non-halal food and beverages;
Shariah non-compliant entertainment;
interest income from conventional accounts and instruments;
tobacco and tobacco-related activities; and
other activities deemed non-compliant according to Shariah.
The 20% benchmark would be applicable to the following activities:
hotel and resort operations;
share trading;
stockbroking business;
rental received from Shariah non-compliant activities; and
other activities deemed non-compliant according to Shariah.
The contribution of Shariah non-compliant activities to the overall revenue and profit before tax of the company will be calculated and compared against the relevant business activity benchmarks.
Note:
Current Shariah screening methodology:

Benchmark	Activity
5%	Conventional banking; Conventional insurance; Gambling; Liquor and liquor-related activities; Pork and pork-related activities; Non-halal food and beverages; Shariah non-compliant entertainment; and other activities deemed non-compliant according to Shariah
10%	Interest income from conventional accounts and instruments; Tobacco and tobacco-related activities; and other activities deemed non-compliant according to Shariah
20%	Rental received from Shariah non-compliant activities; and other activities deemed non-compliant according to Shariah
25%	Hotel and resort operations; Share trading; Stockbroking business; and other activities deemed non-compliant according to Shariah

Financial Ratio Benchmarks
The financial ratios applied are as follows:

i) Cash over Total Assets

Cash will only include cash placed in conventional accounts and instruments, whereas cash placed in Islamic accounts and instruments will be excluded from the calculation.

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CAPITAL MARKETS CHECKLISTS

Islamic Equity Funds

"Economics, as it has been practised in the last three decades, has been positively harmful for most people." Ha-Joon Chang

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Checklist Description

This checklist describes Islamic equity funds, where investors earn *halal* profits in strict conformity with the precepts of *sharia*

Definition

Islamic equity funds (IEFs) are similar to traditional equity funds in that investors pool their funds to invest in shares. However main difference between IEFs and standard equity funds is that investors in IEFs earn halal profits in strict conformity with the precepts of Islamic *shariah*.

Returns are achieved largely through the capital gains earned by purchasing shares and selling them when their price increas Profits are also achieved from the dividends distributed by the relevant companies.

Of course, these funds are not allowed to invest in certain areas. They cannot, for example, invest in companies involved in a that are not lawful in terms of *shariah*, such as alcohol, gambling, or pornography. They also have a restricted ability to invest i areas such as financial companies and fixed-income securities, due to the *shariah* ban on usury. These funds generally avoid and other interest-bearing securities, while seeking protection against inflation by making long-term equity investments.

The first IEF was the Amana Income Fund, established in June 1986 by members of the North American Islamic Trust, the his Islamic equivalent of an American trust or endowment, serving Muslims in the United States and their institutions. The fund is existence today. Prior to the growth of IEFs, few investment alternatives were available to Muslim investors.

A wide variety of investment managers, including major financial institutions, now offer these funds. Examples include Citibanl Deutsche Bank, HSBC, Merrill Lynch, and UBS. Following the growth of IEFs, credible equity benchmarks have been establis including the Dow Jones Islamic Market (DJIM) index and the FTSE Global Islamic Index Series.

Fund managers can use indices such as the DJIM index to screen stocks. The DJIM tracks *shariah*-compliant stocks from arc the world. It eliminates those that fail to meet *shariah* guidelines, including financial ratio filters.

The Islamic equity funds industry had grown to around US$20 billion in assets under management by February 2008, accordi Failaka Advisors, a fund-monitoring company. Failaka Advisors said that the IEFs had grown rapidly, tripling over the previous years, driven by Gulf Cooperation Council investors. Saudi Arabian funds and fund managers dominate the industry, accountir nearly 75 funds out of around 300 IEFs worldwide. Bahrain has become the favored center for fund registrations in the Gulf.

Advantages

- These funds have obvious advantages to Muslims, who can invest their money safe in the knowledge that the fund will n compromise any of their religious beliefs.
- Many funds have been around for a long time and have a good track record of generating healthy returns for their investo
- It can be argued that, over the long term, IEFs will tend to perform better than conventional funds, since the former avoid investing in heavily leveraged companies.

Disadvantages

- The restricted ability of IEFs to invest in certain market sectors limits opportunities and may increase the risk of losses du economic downturns.

- Since Islamic principles preclude the use of interest-paying instruments, the IEFs do not maximize current income becau reserves remain in cash.
- Most of the funds target high net-worth individuals and corporate institutions, rather than the small investor. Minimum investments range from US$50,000 to as high as US$1 million.

Action Checklist

- As with traditional equity funds, the value of an IEF rises and falls as the value of the stocks in which the fund invests goe and down. Therefore, only consider investing in an IEF if you are willing to accept the risk that you may lose money
- Research sites that monitor the performance of IEFs to ascertain which fund is most likely to suit your needs and which h performed the best over a number of years. However, remember that past performance does not necessarily provide a gu how well the fund will perform in the future.

Dos and Don'ts

Do

- Analyze these funds in the same way as you would any other equity investment. Ask yourself whether you are looking fo income or capital gain and whether you are prepared to tie up your money for a long period—most investment managers believe that anyone investing in an equity fund should be prepared to commit for at least five years.
- Ask yourself whether you are prepared to accept the risk involved in investing in equities—stocks go down as well as up.

Don't

- Don't invest without exploring the wide range of funds on the market to find out which is best suited to your needs.
- Don't invest without consulting an independent financial adviser. However, make sure that they are truly independent and earn a commission by recommending clients to a certain fund.

Further reading

Books:

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Siddiqi, Adnan, and Peter Hrubi. *Islamic Investments Funds Versus Hedge Funds*. Munich, Germany: Grin Verlag, 2008.

Halal Investing

Halal investing requires investment decisions to be made in accordance with Islamic principles. As a faith-based approach to investment management, investors often consider *Halal* investing to be a category of ethical or socially responsible investing.

Islamic principles require that investors share in profit and loss, that they receive no interest (*riba*), and that they do not invest in a business that is prohibited by Islamic law, or *sharia*. Before investing in a company, it is necessary to evaluate its business activities and financial records to determine where its primary revenue comes from and how its income and expenditures are managed. A company that meets certain criteria would be *Halal*, or permissible. If it does not meet the criteria, it would be *haram*, or not permitted.

Interpretation of Islamic law as applied to business activities is nuanced, and halal investment guidelines can vary. Therefore, Muslim investors often rely on guidance from Islamic scholars to help determine whether an investment is *Halal*.

Investments that *sharia* scholars universally consider unacceptable are companies whose primary business activities violate the core tenets of Islam, including the manufacture or marketing of alcohol; gambling or gaming activities; conventional interest-based financial services; pork and pork products; and pornography. In addition, most *sharia* scholars advise against investing in tobacco companies.

Islamic scholars have established financial guidelines to determine when a business activity is a core source of revenue and when it is not. For example, the five percent rule says that a core business activity is one that accounts for more than five percent of a company's revenue, or gross income. This reasoning applies to the Islamic prohibition on *riba*, or interest, as well. If a company's interest-based income or holdings exceed certain limits, then investing in the company is forbidden.

giving that can help you cleanse impure investment income by giving it away to acceptable charitable causes. For more information on zakah, and how Saturna Capital can help, please refer to our *Zakah* page.

Halal Investment Screening

Halal investment screens help assess whether a company's business activities are *Halal* or *haram*. The screens facilitate the elimination of *haram* investments from consideration.

Halal investing screens seek to eliminate

- bonds and other interest-based investments
- stocks of companies that have high debt (sometimes referred to as highly leveraged)
- securities of companies in industries that do not adhere to Islamic principles, such as liquor, gambling, pornography, pork, insurance, banks, etc.
- mutual funds or hedge funds that trade securities frequently (have high turnover rates) because frequent trading is seen as gambling by some Islamic scholars

Saturna Capital, adviser to the Amana Funds, employs proprietary screens and an investment process developed in collaboration with Islamic scholars of the Fiqh Council of North America (FCNA), a non-profit organization serving the Muslim community. In addition to the business sector screens listed above, Saturna Capital applies the following financial screens, seeking to eliminate companies with

- greater than five percent of their revenue coming from *haram* sources
- greater than 33 percent total debt as compared to their market capitalization (trailing 12 month average)
- greater than 45 percent accounts receivable as compared to their total assets (trailing 12 month average)

If a company fails the screening process it is considered an unacceptable investment. However, *Halal* investment screening is not always straightforward. When considering whether an investment is *Halal*, it is necessary to look deeply into a company's business activities to discover its core sources of revenue, or how it actually makes its money.

A company's industry sector, or part of the economy to which it belongs, may not always tell you the whole story. A computer software company may write programs used in gambling. A company that publishes children's books may also produce books that are considered pornographic. An agricultural producer might sell its crops exclusively to breweries. On the surface, each of these companies may not appear to be *haram*, but a closer examination reveals otherwise.

Saturna's investment analysts use NEPTUNE® software, developed in-house by Saturna, to screen, grade, and monitor more than 10,000 securities traded worldwide monthly. Securities that receive an "A" grade are subject to further in-depth review prior to purchase.

The *Halal* investment process does not end with a security's purchase. We monitor the securities in the Amana Funds' portfolios for ongoing compliance with *Halal* investing criteria and sell if they fail screens at a later date.

Benefits and Risks of *Halal* Investing

Investing according to Islamic principles can offer many benefits to Muslims and non-Muslims alike. *Halal* investing encourages a disciplined investment process that promotes in-depth security research and monitoring. Generally, the low debt requirements of Islamic screens facilitate a conservative approach that appeals to risk-averse investors.

Halal investing discourages short-term speculation. The low turnover required in *Halal* investment portfolios results in longer planned holding periods and close scrutiny of company financials. Low turnover also minimizes portfolio trading expenses, such as broker commissions, while increasing tax efficiency by avoiding rapid buying and selling of securities that can generate taxable capital gains.

The limitations imposed on investment opportunities by Islamic principles potentially creates risk. For example, among the securities researched monthly by Saturna Capital for the Amana Funds, less than half pass the initial screens necessary to be considered *Halal*. Restricting investment choices to a smaller universe means that a *Halal* portfolio may not be as diversified as other portfolios, which may increase the risk of loss. The returns from various market sectors rise and fall at different times. Islamic principles may limit opportunities to gain when prohibited market sectors, such as financial services, rally.