Journal of Poverty, Investment and Development
ISSN 2422-846X An International Peer-reviewed Journal
Vol.14, 2015

Are Islamic Equity Indices More Efficient Than Their Conventional Counterparts? Evidence from Major Global Index Families

[1]Hussain Ahmad, [2]Muhammad Zahid, [3]Naveed Ahmad, [4]Muhammad Ansar Nazir [5]Muhammad Nouman Shafique [6]Khalil- Ur- Rehman, [7]Raza Ellahi

[1,2]Department of Business Administration, Federal Urdu University of Arts Science and Technology, Islamabad
[3,6,7]Department of Business Administration, Lahore Leads University, Pakistan
[4,5]Ph.D Scholar Preston University, Islamabad

ABSTRACT

The Islamic financial institutions are gaining popularity in recent years. Although this popularity and increasing number of Islamic financial organizations, the Pragmatic research on this topic is less. This pragmatic study will find out the competency of Islamic indices using various statistical techniques. This study also intend to find out the if there is chances to invest in multiple businesses within the Shariah-obedient indices and also check the connection between traditional indices and Shariah-obedient using correlation technique. The sample will include four indices, two of them will comprise of Islamic Shariah-obedient indices and the other two comprise of traditional one. This study disclose that the in competencies intensity of Islamic indices and traditional are same while the indices of MSCI and FTSE is less incompetent. In order to check the relationship between Islamic indices, the correlation technique is used which disclose that Islamic indices of Dow Jones and Standard & poor have negative correlation value with their benchmark, which means that the favorable situation to invest in multiple businesses exist that analysis interpreted as if one indices are not getting profit or facing loss in business then at the same time other indices are gaining profit which thus lower the overall risk of the portfolio and hence provide the favorable circumstances to invest.

Key words: Islamic finance, indices, diversification, co integration, efficiency, variance ratios.

INTRODUCTION

Islamic banking and finance growing speedily and achieve recognition in last few years. The ideologies of Shariah-obedient financial organization are based on Islamic law. In contrast with traditional finance, there are some important characteristic of Shariah-obedient financial institution. The most important characteristic of Shariah-obedient financial institution are interest free business, asset back finances, profit and loss sharing, risk sharing and avoiding too much uncertainty associated with the business. There is also prevention from haram business such as pork, wine, liquor etc.

Islamic mode of financing such as Musharka provides equal risk, profit and loss sharing, thus provides justice and equality. In contrast traditional financial system does not provide the equal profit & loss favorable circumstances. In traditional banking sector, the depositor provides fix income regardless of what bank actually earn. In case of bankruptcy, the bond holder (depositor) could loose all his money which is injustice. Apart from these principles, Islamic finance also addresses some moral and social issues. Like the concept of Murabahah provide some rules how to sell things and prohibit the selling of haram things such as pork, liquor which comprise of ethics in business. Studies found that, Islamic financial institution survive during the era of crises when the traditional financial system failed. Islamic banking and finance growing rapidly and gain popularity in last few years.

Because of growing popularity Shariah-obedient financial institution system, there is a need that a separate equity indices must exist which comprise public companies which compliance with Islamic Shariah laws. Muslim economics and Islamic scholars developed Islamic equity markets so that Muslim investor can invest in businesses which purely follows Islamic principles and

Shariah rules and can earn profit in accordance with the Islam teachings. Rules and regulations developed in order to examine the pubic companies whether they are in accordance with Islamic laws or not.

There is a managerial board which check the eligibility of the public company and also a Shariah board which confirm that the companies are in accordance with Shariah rules and regulations..

Islamic indices were initially created in late nineteenth century. There are multiple indices created which also comprise of local indices as well as worldwide indices which comprise of internationally traded public companies.DMI 150 started by two private banks. The aim of these indices is to provide the behavior of one hundred and fifty organizations which trade globally.DMI include all publically traded companies. SAMI was also formed in the same year which is larger indices than DMI as discuss before, the SAMI comprise of five hundred publically traded organizations and provide the behavior and competency of these businesses.

After the start of these two indices (DMI & SAMI) more Shariah-obedient indices come into existence in order to provide investor the service so that they can check the performance of these publically traded companies which are in obedient of Shariah law and can invest in these companies according to their faith and belief. In 1999 Dow Jones formed DJIMI. FTSE Group formed GIIS which stands for (Global Islamic Index Series) at the London Stock Exchange in 1999. These are internationally traded companies Shariah-obedient indices however some Shariah-obedient indices are created locally which means that local Shariah-obedient indices which serve local needs. So they provide the investor the favorable circumstances to check the performance of the companies who sell their products locally. India, Malaysia, Pakistan, Saudi Arabia, Egypt and Turkey which have created their local Shariah-obedient indices in order fulfill the local needs.

Screening of Shariah-obedient indices create indistinctness among scholars because the authorized level by Shariah board is not same for all Shariah-obedient indices hence there is no accord between all the scholars on this issues and could not get undisputed approval of scholars. The indistinctness exist because some Shariah board allow organizations which follow key business activities in agreement with the Shariah Law but some unlawful transaction also exist which are not key business activities but these transaction are not in accordance with Shariah law.

Using correlation analysis statistical techniques in order to test the relationship between two Shariah-obedient indices whether there exist o to invest in multiple businesses with favorable circumstances between the Shariah-obedient indices or not. The correlation technique is widely used to check the correlation between the two assets. If there were positive correlation then it means there is no of to invest in multiple businesses in favorable circumstances exists if test found negative correlation between the securities. The more the stronger form of correlation the less the risk is associated with that particular portfolio or indices.

This study apply correlation statistical tool to test whether there exist any chance to invest in multiple business with favorable circumstances. Study found that relationship between Shariah-obedient indices Dow Jones and Standard and Poor's is not correlation and there exist diversification favorable circumstances. When apply this test to the remaining other to indices which is FTSE & MSCI, the study reveal that they are correlation, hence lack of diversification favorable circumstances. Existing of correlation means that if one index produces return then other index at the same time also produces return while if there is no correlation then it means that if one index facing loss then other index at the same time produce return which reduces the risk in portfolio and give favorable circumstances to invest in multiple business.

These studies also apply another statistical tool called variance. Variance or standard deviation statistical tool is used to test the risk associated in each security or Shariah-obedient indices i.e. how they deviate from the mean. This tool applies in Islamic Financial Institution and

Traditional Financial system. Our result found that same level of risk is associated with the Islamic and traditional financial system and there is no difference between the two. The variance also apply in Dow Jones and S& P and study found that the same level of risk associate in these Shariah-obedient indices while when apply variance test on FTSE & MSCI then test found that they are less risky as compared to Dow Jones and S&P.

LITERATURE REVIEW

The factual period of Islamic organization has been started in mid seventeen of century. In eighteenth century the Islamic organization was at developing stage and at that period the model of Shariah-compliant Islamic organization was also disparage by some researcher. However in nineteenth century Islamic organization has matured noticeably and world is gaining interest in these Islamic modes of financing. These models are getting popular in both Muslim and nonMuslim community.

The development of Islamic capital market motivate researcher to research on Islamic Shariahobedient indices in order to check the behavior of Islamic indices and compare them with traditional indices and to spot if any difference exist between the two. Both quantitative and qualitative studies have been performed. The number of qualitative studies has been performed in recent years with the aim to focus on Islamic principles followed by business and Islamic framework of capital market. Studies which are conducted in the Islamic agenda of capital market is to analyze the practicability of Islamic Shariah-obedient indices, the rules and regulation follow by these indices and to compare it with Shariah law.

Number of Islamic Shariah-obedient indices has been structured and achieving recognition recently. The international Islamic Shariah-obedient indices where the listed stocks are international public companies. These companies doing business across the border and sell their product and services internationally. Beside international Islamic Shariah-obedient indices, a considerable number of local Shariah-obedient indices were also created in recent years in order to fulfill the local needs. The local Shariah-obedient indices created in different Muslim countries to cater the local needs. These countries include India, Pakistan, Egypt, Saudi Arabia,

Iran and Malaysia. The most popular Islamic Shariah-obedient indices are located in Malaysia. The Malaysian Islamic Shariah-obedient indices are created which give the favorable circumstances to investor to invest in securities which are Shariah-compliant and earn profit without conciliation their Islamic belief. Numerous studies have so for conducted in these

Shariah-obedient indices. Notable researches are conducted by Ahmad and Ibrahim (2002) on Kuala Lumpur Shariah index. So far very few studies have been conducted on diversification opportunities of these Islamic Shariah-obedient indices and quantitative research is conducted using statistical techniques which is correlation to find out the existence of chances to invest in multiple businesses and also the variation tool to find out the jeopardy involve in each security and portfolio.

Conclusion

Islamic indices were launched to open the opportunities for investment in equity market by the investors according to their ethical commitment. This paper attempts to answer the question whether these indices offer an opportunity for portfolio diversification or not and whether they have the same efficiency level as their conventional counterparts or not. This paper, in order to answer these questions, analyzes four pairs of global Islamic and conventional indices covering the most important index families (Dow Jones, FTSE, Standard & Poor's, Morgan Stanley). Our study contributes to the current literature by addressing two main shortages. Firstly, we study the potential for diversification among pairs of indices as computed by globally reliable indices' providers. Secondly, we explore the area of the efficiency level of Islamic indices in relation with their conventional benchmarks. Two Islamic indices families included in our sample have not been studied before in the literature because of the short histories and some methodological difficulties linked to the size and the industry-weighting differences among indices.

References

Ahmad, Z., and H. Ibrahim. 2002. A Study of Performance of the KLSE Syariah Index. *Malaysian Management Journal* 6 (1-2): 25-34.
Ahmad, A. 1997. *Towards an Islamic Financial Market/ a Study of Islamic Banking and Finance in Malaysia*. Research Paper N°45, IRTI, Islamic Development Bank.
Albaity, M., and R. Ahmad. 2008. Performance of Syariah and Composite Indices: Evidence from Bursa Malaysia. *Journal of Accounting and Finance* 4 (1): 23-43.
Alhabshi, S. O. 1994. Development of Capital Market under Islamic Principles. *Conference on Managing & Implementing Interest-Free Banking*, January 25-26, Kuala Lumpur, Malaysia.
Annuar, M. N., M. Shamsher, et M. H. Ngu. 1997. Selectivity and timing: evidence from the performance of Malaysian unit trusts. *Pertanika Journal of Social Science and Humanities* 5(1): 45-57.
Anwar, M. 1995. An Islamic Perspective on Capital Markets and "Islamic" Securities in Malaysia. *The Pakistan Development Review* 4(34): 865-878.

Arouri, M.E.H., H. Ben Ameur, F. Jawadi, N. Jawadi, and W. Louhichi. 2012. Are Islamic finance innovations enough for investors to escape from a financial downturn? Further evidence from portfolio simulations. *Applied Economics*

Binmahfouz S., and K. Hassan. 2012. "A comparative study between the investment characteristics of Islamic and socially responsible investment portfolios: Evidence from FTSE indices family" *International Conference on Islamic Capital Markets*, 19-20 June, Jakarta, Indonesia

Dabbeeru, R. N. 2006. Performance Analysis of Mutual Funds in Saudi Arabia. *SSRN eLibrary*. http://ssrn.com/paper=921523

Derigs, U., and S. Marzban. 2008. Review and Analysis of Current Shariah-Compliant Equity Screening Practices. *International Journal of Islamic and Middle Eastern Finance and Management* 1 (4): 285-303.

2009. New Strategies and a New Paradigm for Shariah-Compliant Portfolio Optimization. *Journal of Banking and Finance* 33(6): 1166-1176.

Ebrahim M.S., and A. Safadi. 1995. Behavioral Norms in the Doctrine of Islamic Economics: A Comment, *Journal of Economic Behavior and Organization*, 27: 151-157

El-Gamal M.A., 2002 "An Economic explanation of the Prohibition of Gharar in Classical Islamic Jurisprudence" in *Islamic Banking and Finance: Current Developments in Theory and Practice*. p. 49-88, Edited by M. Iqbal, Islamic Foundation Leicester, UK. 2006, "Islamic Finance: Law, Economics and Practice", Cambridge University Press.

Elgari, M.A. 1993. Towards an Islamic Stock Market. Islamic Economic Studies, 1(1):1-20.

Engle, R. F, and C.W.J Granger. 1987. Cointegration and error correction: Representation, estimation and testing. *Econometrica* 55 (2): 251-276.

Fama, E.F. 1965. Random walks in stock market prices. *Financial Analysts Journal* 21 (5): 55–59.

Fowler, S. J, and C. Hope. 2007. A critical review of sustainable business indices and their impact. *Journal of Business Ethics* 76 (3): 243–252.

Ghoul, W., and P. Karam. 2007. MRI and SRI Mutual Funds: A Comparison of Christian, Islamic (Morally Responsible Investing), and Socially Responsible Investing (SRI) Mutual Funds. *Journal of Investing* 16 (2): 96.

Gilmore, C.G. and McManus G. 2003. Random-walk and Efficiency Tests of Central European Equity Markets, *Managerial Finance*, 29: 42-52.

Girard, E., and M. K. Hassan. 2008. Is There a Cost to Faith-Based Investing: Evidence from FTSE Islamic Indices. *The Journal of Investing* 17 (4): 112-121.

Guidi, F., and R. Gupta. 2011. Are ASEAN stock market efficient? Evidence from univariate and multivariate variance ratio tests. Discussion Papers in Finance, n°13, Griffith University.

Guyot, A., 2011. Efficiency and Dynamics of Islamic Investment: Evidence of Geopolitical Effects on Dow Jones Islamic Market Indexes. *Emerging Markets Finance and Trade* 47 (6): 24–45.

Hakim, S., and M. Rashidian. 2002. Risk & return of Islamic stock market indexes. 9th *Economic Research Forum Annual Meeting,* 26-28 October, *Sharjah UAE.*

2004. How Costly is Investors' Compliance to Sharia? *Proceedings of the 11th Economic Research Forum Annual Conference. Sharjah, UAE.*

Hassan, M. K. 2001. Risk, Return and Volatility of Faith-based Investing: the Case of DJIM. Boston, Massachusetts

Hoque, H. A.A.B., J. H. Kim, and C. S. Pyun. 2007. A comparison of variance ratio tests of random walk: A case of Asian emerging stock markets. *International Review of Economics & Finance* 16 (4): 488-502.

Hussein, K. 2004. Ethical Investment: Empirical Evidence from FTSE Islamic Index. *Islamic Economic Studies* 12 (1): 21-40.

Iqbal, M. 2002. *Islamic Banking and Finance: Current Developments in Theory and Practice*. Islamic Foundation, Leicester, UK.

Jobst, A.A. 2007. The Economics of Islamic Finance and Securitization. *Journal of Structured Finance* 13 (1): 6-27

Kuran, T. 1983. Behavioral Norms in the Islamic Doctrine of Economics: A Critique, *Journal of Economic Behavior and Organization* 4: 353-379

Khan, F. 2010. How 'Islamic' is Islamic banking?. *Journal of Economic Behavior & Organization* 76: 805-820

Kok, S., G. Giorgioni, and J. Laws. 2009. Performance of Shariah-Compliant Indices in London and NY Stock Markets and their potential for diversification. *International Journal of Monetary Economics and Finance* 2 (3): 398–408.

Kurtz, L. 2005. Answers to four questions. *Journal of Investing*, Fall: 125-139.

Lo, A. W., and A. C. MacKinlay. 1988. Stock market prices do not follow random walks: Evidence from a simple specification test. *Review of financial studies*: 41-66.

Malkiel, B.G. 2003. The Efficient Market Hypothesis and its Critics. *Journal of Economic*

Perspectives 17 (1): 59-82
Miglietta, F., and G. Forte. 2007. Islamic Mutual Funds as Faith-Based Funds in a Socially Responsible Context. Luigi Bocconi University, Milan.
Naughton, S., and T. Naughton. 2000. Religion, ethics and stock trading: the case of an Islamic equities market. *Journal of Business Ethics* 23 (2): 145-159.
Nishat, M. 2004. Experience of Equity-based Islamic Shares in Pakistan. *Pakistan Development Review* 41 (2): 583-602.
Obaidullah, M. 2001. Ethics and Efficiency in Islamic Stock Markets. International Journal of Islamic Financial Services 3 (2): 1-10.
Smith, G., and H. J Ryoo. 2003. Variance ratio tests of the random walk hypothesis for European emerging stock markets. *The European Journal of Finance* 9 (3): 290–300.
Tilva, R., and J. Tuli. 2002. Islamic Banking: A new era of financing. Google Scholar.
Wright, J. H. 2000. Alternative variance-ratio tests using ranks and signs. *Journal of Business & Economic Statistics* 18 (1): 1–9.
Yaquby, N. 2000. Participation and Trading in Equities of Companies whose Main Business is Primarily Lawful but Fraught with some Prohibited Transactions. *Fourth Harvard Islamic Finance Forum*. September 30–1st October.
Yusof, R. M., and M. S. A. Majid. 2007. Stock Market Volatility Transmission in Malaysia: Islamic Versus Conventional Stock Market. *Journal Islamic Economics* 20 (2): 17-35.