

Shariah vs conventional: Which funds are better?

- In times of a global financial crisis, Islamic finance is considered to be a less volatile option
- The increasing awareness of socially responsible investing is perhaps a factor in the growth of Islamic finance



by
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There has been growing interest globally for Shariah-compliant funds in recent years. The Malaysia Islamic International Financial Centre reports that by the end of the first quarter of 2017, total global Islamic assets under management were US\$70.8 bil (RM292.3 bil compared to US\$47 bil in 2008.

First, some background information on Shariah-compliant fund. It is a type of investment fund that abides by Shariah law and Islamic principles.

Take note that in the realm of Islamic finance, banks are not allowed to charge interest and do not fund companies or projects that are associated with alcohol, tobacco or gambling.

It is regarded as a type of socially responsible investment. Investment portfolios are carefully screened by experts to make sure that they tick every box on a comprehensive list of criteria that are in accordance with Islamic principles.

Socially responsible investing is the hot topic in financial circles around the world and interest in it is at an all-time high.

Simply put, a socially responsible investor actively chooses companies or funds that contribute to the betterment of the environment, social rights and such.



Islamic finance does not allow for speculative trading which is able to help ensure financial stability

But for investors, their main objective is to generate the best possible returns on their investments. Is it better to put your money in Shariah or conventional funds?

Maybank Asset Management Sdn Bhd CEO Ahmad Najib Nazlan tells *FocusM*, "There are no specific indications that returns from Shariah-compliant funds are higher or lower than conventional funds in Malaysia.

"However, from the availability and limitation of assets within Shariah-compliant funds, one would expect that conventional funds should provide better opportunity for outperformance due to its wider universe.

"Nevertheless, the awareness and growing affluence of the socially responsible attributes of Shariah-compliant funds may overwhelm the pure returns of conventional funds.

"Hence, we can expect that over time, Shariah-compliant funds may provide better returns than conventional funds due to their socially responsible attributes to the premium valuation of Shariah-compliant assets.

"Anecdotal evidence from a 10-year track record shows that FBM Shariah had a steeper growth over FBMKLCI's conventional universe."

Increasing interest

Shariah finance was more in use in Muslim-majority countries in the Middle East and Southeast Asia in the past but things have changed. It has gained traction among investors all over the world.

Ahmad Najib adds, "There has been an increase in a wide range of Shariah-compliant investment products and services available to individual and institutional inves-

tors locally and internationally.

"Not only do Shariah-compliant investments appeal to Muslims worldwide but it is beginning to appeal to non-Muslims too, who are attracted by its core ethical principles.

"Hence, the market for Shariah-compliant investments have been growing as investors are becoming more interested in socially responsible investments and additional sources of portfolio diversification.

"Islamic assets under management were RM172.89 bil in June 2019 versus RM164.12 bil in January 2019."

He points out that the main benefits from investing in Shariah-compliant funds other than the compliance part could be the fulfilment of socially responsible investment objectives by investors.

"Shariah-compliant funds also provide competitive returns against conventional funds," he shares.

In fact, ICD-Thomson Reuters Islamic Finance Development found that the number of higher education institutions that include Islamic finance degrees in their programmes increased to 191 in 2016 from 141 in 2014.

The industry is flourishing as countries and companies need to expand their pool of investors and funding sources. Islamic products like sukuk could help issuers reach Muslim investors who cannot be involved in conventional funds.



"Shariah-compliant funds screen out most of the unethical stocks and activities such as gambling, tobacco and alcohol."

- Ahmad Najib

As the industry grows and services for the issuance of sukuk become increasingly available, the financing costs gap between sukuk and conventional bonds is narrowing.

In the past few years, Islamic
Continues next page

Shariah Terminology

- **Dharar** - Harm
- **Gharar** - Uncertainty
- **Ijarah** - Lease or service contract that involves benefit/usufruct of a certain asset or work for an agreed payment or commission within an agreed period
- **Mudarabah** - Profit sharing contract
- **Musarakah** - Profit and loss sharing
- **Sukuk** - Islamic securities/bonds
- **Sukuk ijarah** - Islamic securities based on an ijarah contract
- **Ujrah** - Commission
- **Wadi'ah** - Safe-keeping contract in which a party entrusts one's property to another party for safe-keeping and to be returned upon request

Source: Bank Negara Malaysia

Need to have more Islamic finance products

From previous page

funds have shown more stability than conventional ones. Shariah-compliant investment is deemed to possess defensive qualities as portfolios are screened carefully to eliminate stocks that are too risky.

In times of global financial crises, investors may want to play it safe and Islamic finance is considered to be a less volatile option compared to conventional funds.

Islamic finance does not allow for speculative trading, and this helps ensure financial stability.

Shariah-compliant funds have also caught the eye of investors who want to grow their wealth in a more responsible manner.

Moreover, the increasing awareness of socially responsible investing may have also been a factor that led to the spurt in Islamic finance as both have similar values and principles.

“Socially responsible investments may cover a lot of strategies that are aligned to certain values and beliefs of investors.

“Shariah-compliant funds screen out most of the unethical stocks and activities such as gambling, tobacco, alcohol and interest-bearing activities like conventional banks do. Shariah-compliant funds can be aptly parked under socially responsible investment,” says Ahmad Najib.

As investors, especially those in the affluent category, increasingly show interest in adopting a more ethical approach, Islamic products in the market need to be increased as well to cater to this growing demand.

Features of Islamic finance

Under Shariah principles, money has no intrinsic value. One of the core principles underlying the Shariah banking system is prohibiting the charging of interest when lending or borrowing money.

The operation of Islamic finance centres around two core principles - the sharing of profit and risk, and the prohibition of earning via interest.

According to Ahmad Najib, the differences between Shariah-compliant funds and conven-



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tional funds are mainly in the following areas:

- Objective of the fund
- Structure
- Investment strategy
- Operations and management
- Documentation
- Investment avenues and activities
- Accounts and reporting

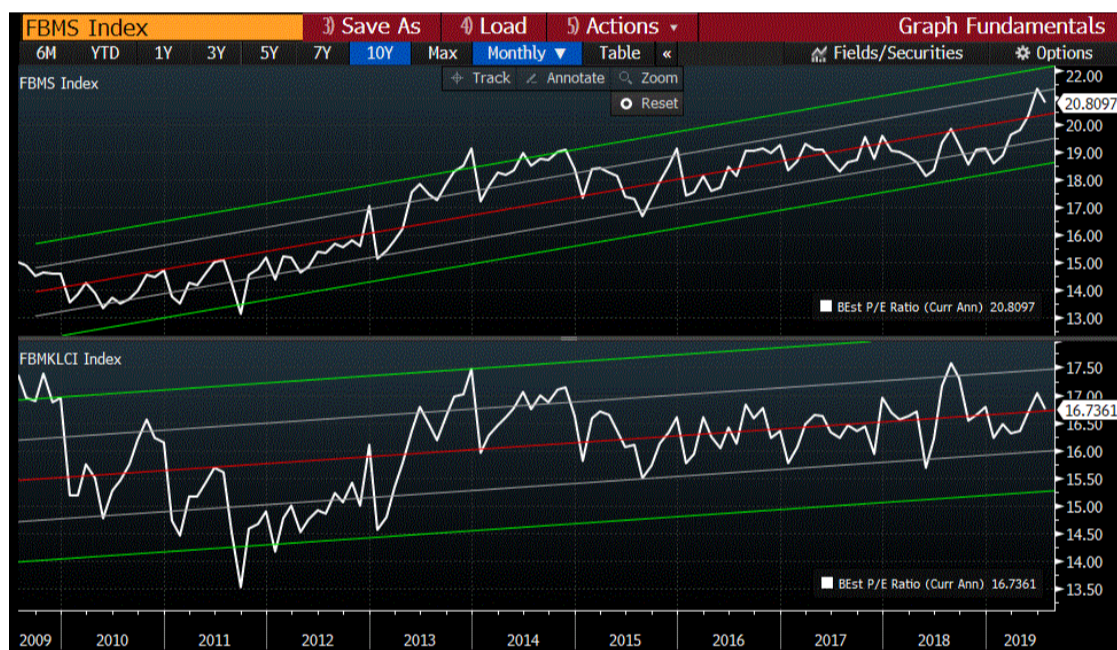
He adds that the main objective of an investment fund is normally to maximise returns from capital and income growth.

For Shariah-compliant funds, the investment strategy will need to be in accordance with Shariah principles and approved by Shariah advisers.

“As for the operations and management of Shariah-compliant funds, they must comply with all the Shariah requirements set by the Securities Commission and other relevant competent Shariah authorities.

“Hence, the appointment of a Shariah committee or Shariah adviser to the funds is required to ensure that the funds are managed and administered in accordance with Shariah requirements.

“Other factors that may differentiate Shariah-compliant funds from conventional funds



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can be in the manner of cash balances in the funds being placed in just Islamic institutions approved by the Shariah advisers and the requirement for the fund to be attested as Shariah-compliant on an annual basis,” he says.

Also, banks cannot charge interest and instead earn an

income by helping customers to buy properties through ijarah or murabahah.

An ijarah scheme allows the bank to earn by charging customers rent while in a murabahah scheme, the price of the property is agreed to from the beginning. The price includes

some profit and is a reward for the bank for assuming the risk.

Islamic banks also use equity participation systems. Rather than earning interest when lending money to businesses, equity participation dictates that businesses accord the bank a part of its profits. FocusM

Investing in a socially responsible manner

ACCORDING to news reports, more than US\$12 tril (RM50 tril) are parked under funds that are socially responsible investing (SRI)-compliant.

SRI ensures that investors' portfolios are in accordance to their values and as the name implies, generally involves companies that dedicate efforts to social justice, environmental sustainability and clean technology.

It takes into account not only an investment strategy that gives good financial returns but also contributes to social and environmental matters positively.

Similar to Shariah-compliant investing, they also do not fund activities that involve addictive substances and vices like alcohol, gambling and tobacco.

Such SRI and funds that go to environmentally, socially and governance-friendly (ESG) projects have also increasingly caught the eye of younger investors.

Investors of the Gen Z and millennial generation put a lot of thought into where their funds go and whether the funds they invest in share the principles they stand for.

Not only that, investment research firm Morningstar reports that 72% of all investors show at least a moderate interest in such investments.

While the younger investors care more about keeping the earth green and human peace, boomers tend to go for diversity and religious matters.

In addition to doing their part in contributing to envi-

ronmental sustainability or social issues, SRI investors also tend to enjoy better performance than conventional investors although returns can differ from year to year.

Investing in SRI or impact funds does not mean that one has to trade performance for contributing to issues one values.

ESG criteria used by investors include green building, clean technology, employee rights and even animal welfare.

But investors need to know that using these unique strategies can often cost more as a team of experts is usually required to do the screening and research on the portfolios and this adds to the costs.