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.

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.

While some background information on Shariah-compliant funds is available, there is perhaps a factor in the growth of Islamic finance.

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 socially responsible attributes of funds. Is it better to put your money in Shariah or conventional funds?

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.

And 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 investors 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 fulfillment 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.

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 Shariah-Terminology

- Dharar - Harm
- Gharar - Uncertainty
- Ijarah - Lessee service contract that involves benefit/loss of a certain asset or work for an agreed payment or commission within an agreed period
- Mudarabah - Profit sharing contract
- Musharakah - Profit and loss sharing
- Sukuk - Islamic securities/bonds
- Sukuk ijarah - Islamic securities based on an ijarah contract
- Urah - Commission
- Waqaf - 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

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

- Ahmad Najib

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**Need to have more Islamic finance products**

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Funds have shown more stability than conventional ones. Shariah-compliant investment is deemed to be less defensive in nature as profit and risk, and the prohibition of interest when lending money.

In times of global financial crises, investors may want to play it safe and Islamic Finance is considered to be 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. "Other factors that may differentiate Shariah-compliant funds from conventional funds are mainly in the following areas:

- Objective of the fund
- Investment strategy
- Operations and management
- Investment avenues and activities
- Accounts and reporting
- Shariah advisory service

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 funds are managed and administered in accordance with Shariah requirements.

Other factors that may differentiate Shariah-compliant funds from conventional funds can be in the manner of cash balances in the funds being placed in just Islamic institutions approved by the Shariah advisors 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 other participation schemes. Rather than earning interest when lending money to businesses, equity participation dictates that businesses accord the bank a part of its profits.

**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 with 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 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 awareness of socially responsible investing. They 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.