Islamic Equity Funds

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What is an Islamic Equity Fund?

An Islamic equity fund is a portfolio of shares of companies, selected on the basis of certain Islamic principles, and managed with a consideration of pre-set Shari'ah parameters. An Islamic equity fund is basically "ethical investing".

Ethical Investing is not new. It goes back to the 1920's. They became popular, however, in the 1970's and thereafter. In 1971 a group of Methodist clergy in the USA discovered that their church regularly received letters from individuals asking how to invest in companies not manufacturing weaponry. After finding that no organization specializes in this kind of investment, the ministers went to Wall Street firms asking for assistance in setting up a fund for this purpose. Pax World Fund may be the first equity fund to adopt a full set of ethical issues in its screens. The pioneer fund which excluded companies producing alcohol & tobacco from its portfolio holding was available to investors in 1928. Then the environmental movement and the equal employment opportunities programs in the 1970's produced a number of equity funds tailored to the preferences of investors who are concerned about these issues, and want their money to help influence the business sector into more compliance. Dreyfus third century fund was pioneering in this regard. Such funds do exist now in USA & Europe.

Islamic Equity Funds are, therefore, part of a larger group of ethical investment programs. They address the needs of a class of investors, who are concerned about public issues, social justice or certain individual preferences. However, the main concern of Islamic "ethical" investor is the sources of his income. He is obliged religiously to make sure his earnings always come from "clean" sources. Therefore, there is no share holder's activism in Islamic equity funds. Islamic investors don't attempt to make a statement Vs corporate management, and feel no duty to influence corporate action.

THREE SHIFTS IN ISLAMIC BANKING:

Islamic equity funds came a mid fundamental shifts that were taking place in the development of Islamic banking in the 1990's. These changes gave rise to these Islamic equity funds and other investment and financial innovations, and will sustain a phenomenal rate of growth for them in the near future. They are:

1. From defensive to positive Islamic banking:

In the 1970's & 1980's the major concern of the clients of Islamic banking is just the avoidance of interest. Islamic banks, at that time, were "brimming" with free-money in current account deposits. The major worry of these deposit holders was to make sure that their funds are distend from usurious transactions. The 1990's witnessed an important shift. More & more Muslims who want to stay away from interest, also want their money to earn a return. This created opportunities for innovations to bring to the market investment programs that, while abiding by the Shari'ah prohibition of interest they are capable of providing reasonable return on investment.

2. From Non-Islamic to Islamic:

Islamic religious revivalism is now disseminated into segments of the Muslim societies which are wealthy, more influential and educated. These groups of people are not new to business & investment but their religious solace included a movement from conventional to interest-free banking. It is because of this private banking departments catering primarily to HNW individuals are the most active in the provision of Islamic banking service in many conventional banks. Islamic equity funds are responding to the needs of this group of investors.

3. From local to international:

Banking and financial services are being globalized. Islamic banking and investment are no exception. More & more Muslims now are looking outward, searching for investment opportunities beyond the boundaries of their home countries. They no longer identify Islamic banking with Muslims or Muslim countries. An increasing number of investors are adopting selection criteria based on examination of the transactions and investment offers to ascertain Shari’ah compatibility, rather than relying on the vender name. This created opportunities for major financial institutions in the west to cater to the needs of these investors. Equity funds play a major role in this regard.

ISLAMIC EQUITY FUNDS ARE RECENT PHENOMENON:

The oldest Islamic Equity Fund offered the public goes back to only 10 years. But it is only in the last 3 years that such funds became very popular. While official statistics are available, my own estimate is that there is no less than 20 Shari'ah guided equity funds world wide, with assets of more than $ 2 billion. Furthermore, the rate of growth of subscriptions in these funds is exceeding 20% a year. This means that the market for Islamic equity funds is “on its way” to becoming a significant “niche” market in the world of global investment.

THE RELIGIOUS FOUNDATION OF THE ISLAMIC EQUITY FUND DESIGN:

Like any legal system, Shari’ah is a set of do’s & don’ts. The difference, however, is that Shari’ah is not just worldly, but a part of a system of beliefs that relates life to the hereafter. Therefore, a believer is supposed to internalize in his method of judgment and “cost-benefit” analysis this aspect of heaven & hell. This means that, through Shari’ah, the now and the hereafter are united into one spectrum. Because of this, believers are keen to make sure that their investment decisions are in tune with religious requirements by abiding by Shari’ah rules. As a result Shari’ah approval of structure & operation is the most important element of the working of equity funds.

SHARI’AH ASPECTS OF ISLAMIC EQUITY FUNDS:

Investment funds are created when investors pool their money for a shared investment goal. Collective power affords an opportunity to participate in a well diversified, professionally managed investment portfolio. To be acceptable from Shari’ah point of view, it is essential to examine certain aspects of investment funds. In particular we will evaluate the contractual relationships between the parties involved in the working of a fund, choice of portfolio holdings as well as some operational elements of such funds.

A. Contractual Relationships:

Shari'ah is the Islamic Law. Contractual relationships in any transaction are the most relevant aspects to Shari'ah scrutiny.

The most visible is the relationship between investors and the manager of the fund. Fund management may be based on *Mudarabah*, where the manager, either individual or institution, the Mudarib and the investors are rab-ul-mall (providers of funds). In such a case, manager will only share in the profits generated. Sharing of profit must be in accordance with the ratio spelled-out in the prospectus which constitutes, from Shari’ah point of view, a contractual relationship. His income will be based on the difference between the initial NAV and the NAV at the pricing date which represent profit in such arrangement. Pricing date represents the accounting liquidation of the Mudarabah.

Many managers would not like their compensation to be tied to profit, but rather prefer to get a fixed remuneration. In such case, the relationship can be based on the Ijarah (hire) contract. The manager, in this case is hired by the fund which inturn represents the collective will of the Investors. The manager is, then entitled to an income linked to his managerial effort. Most investment funds management is based on such arrangement. In this case, the manager charges a percentage of the NAV at the pricing date. Ijarah is a permissible contract. However, compensation in the Ijarah contract, like any exchange contract in *Shari'ah*, must be known at the beginning of the period (time of contracting) not the end (time of liquidation). Otherwise *gharar* will be present which may void the contract. Such compensation will not be known exactly at the time of contracting (since it is based on end-of-the-term NAV), but only known in approximate amount, which reduces such *gharar*, though by no means eliminate it. Although the writer is of the view that such Ijarah is permissible, there are some contemporary scholars who think otherwise. Making compensation for the next period depend on last period's NAV is a straight forward solution. In a lot of cases many institutions participate in the "management" of the fund. Some of them may handle the marketing leg of the operations and one takes care of the actual execution of transactions.

B. <u>Restrictions on the types of equities in the fund:</u>

This could be the most important aspect of Islamic Equity Funds. We can classify the Shari'ah restrictions on the types of equities in the fund in two categories:

(a) Restrictions related to the area or the core business of the company whose equities are to be held by the fund: Any company whose business activities are basically in the non-permissibles is not suitable for an Islamic equity fund. The list is not very long and it includes financial services banking, insurance companies, gambling, liquor, port, pornography . . . etc. Notice here that we are talking about the "core" of the business activities of the company. A big company whose cafeteria in the headquarters building sell beer don't present a violation of this restriction. Border-line cases, however, can only be resolved by a Shari'ah board on a case by case basis.

(b) Restriction related to the finances of the company. This is an operational restriction. A company that is already short-listed through our first screen may still be unsuitable for an Islamic equity fund. It is important that such companies are not engaged in non-permissible financial transactions. Certainly it would be preferable if one can find companies so pure that they depend completely on their own income, and always rely on self financing. But this is hardly possible. The question becomes, then, how to set parameters that guarantee selection of companies with minimal involvement in such non-permissible financial transactions. These parameters are:

1- **Debt to equity ratio:** The problem with debt in the capital structure of a company, from an Islamic point of view is that it is interest based. A company indebted through Murabaha, for instance, need not have any such restriction. Borrowing on interest is not permitted, therefore it is necessary that such borrowing is limited to a tolerable level. In certain situations Shari'ah treats minute and insignificant amount of non-permissibles as negligible having no effect on the permissibility. But what is the cut off-point? There are many indications in Shari'ah which points out to the "one third" as "plenty", and that anything less than one third is "trifle". Though such distinction came in a different context, many contemporary Shari'ah scholars thought it relevant and assumed that a debt to equity ratio of less than 1/3 is tolerable. It is extremely important to note that such. criteria will never be suitable for wine production for example. This because, as we mentioned above, hardly any company can do without some debt. Our objective here is, therefore, to measure the extent of the firms financing with debt. Debt to equity ratio represent the relationship between funds supplied by creditors (debt) and investors (equity).

2- **Interest earning:** Companies whose core business is production of goods and services draw their income from profits generated from sale of such goods or services. It is not likely for any such company to earn any significant percentage of income from interest. It does happen, however, that excess cash is deposited in interest-bearing account or invested in money market instruments. This amount must be identified and investors should be advised to set aside what ever such percentage constitute out of the portfolio returns on investment. The investor may then donate the same to his favorite charity. Such amounts are usually very limited.

3- **Cash and Receivables:** Shari'ah distinguishes between sale of real good and that of money and debt. In the latter such sale can only be done at par value. The share of any company don't actually have an existence of its own but its value comes from the undivided portion of the assets of the company it represent. Therefore, when one buys a share he is actually buying these assets. If the latter are primarily cash and receivables then the market value of the share must be equal to the face value of these assets. Any thing more (or less) may be considered usurious from Shari'ah point of view. Because such pricing is not possible in practice, a restriction is imposed to eliminate the likelihood of such thing. This could be done by, again, putting a cap on the size of such class of assets.

4- **Source of information:** The main source of information from which data that can help make the right selection for all Islamic equity fund is the balance sheet of the company and its income statement (profit & loss account). These are the usual sources of financial information about any company. It may be agreed that both reflect the state of a company's finances only one day in the year. While this is true, there is unfortunately no alternative.

C. <u>Reserves:</u>

Reserves are important to the proper management of the fund and the smoothing of redemption payments to the investors. If distribution of profit and redemption of units is done on accrual basis, then reserves are a must for the operation of the fund. Reserves are deducted from the profit generated through the invested funds. This raises two Shari'ah questions. Firstly, whether investors are aware of such deduction and they are consenting to their amount. This problem can be solved through clear mention in the prospectus and signed on the agreement with each investor. Secondly, who own such reserves at the winding down of the investment fund ? Many investment funds that are managed by Islamic banks opt for donating such amount at the closing of the fund to charity. One should remember, however, that most of these open-end funds have no specific date nor any future plan for ending the operation of the fund.

D. Guarantee of capital of the fund by the manager:

To attract investors, many conventional fund managers guarantee to the investors the nominal value of their investment. This is not acceptable from *Shari'ah* point of view. Many advanced to a manager that guarantees it return at the end of the period (or at any time in the future) makes it, from contractual point of view, a lender-borrower relationship. Profit on such money will then be a form of usury (*riba*), even of such profit is variable. In an Islamically managed fund no such guarantee should be made.

E. Gearing:

One of the most important advantages of investment funds in conventional setting is gearing, i.e., the possibility of pledging the assets in the fund for borrowing and re-investing to enhance the earning in the fund. This is clearly not acceptable from *Shari'ah* point of view since these borrowings are interest based.

The rationale behind this approach, is to have some resources in the fund that receive fixed return. Because the fund can generate higher earnings than that fixed return, then participants will have their return on investment improved. It is not wholly unlikely that an Islamically acceptable design to the same effect. For example, the fund can purchase some assets on Murabahah basis using the rest of assets in the fund as collateral.

F. <u>Hedging market risks:</u>

Equity markets are volatile, which exposes the invested funds to significant risks. It is customary that fund management engage in certain transactions for the purpose of hedging these risks. The most used means for this purpose are to sell index futures, write call options on stock indices or purchase put options. In investment funds that cover different markets and take cross-border risks, currency hedging may be necessary. Managers may engage in currency forward contracts, put and call options to hedge currency risk. Unfortunately, most of these transactions are not permissible from Shari'ah point of view. Hence non of the above can be practiced by the Funds management.

G. <u>Other transactions:</u>

For the purpose of efficient portfolio management, manager may go into certain transaction such as securities lending and repurchase agreement. As for the latter, repurchase agreements are not permitted for the sale of any item, from Shari'ah point of view, must not include a repurchase. While lending is permitted from Shari'ah point of view no increase is allowed. Therefore, lending of securities can be done free. However because this is not likely to happen, then this is not affective.

H. The Process of "Cleansing":

The basic concept of an Islamic equity fund is based on the idea that the Investor will be able to rid his earnings from the portion that is coming from interest, and that such procedure will be attainable to him through the assistance of the manager.

It is essential, therefore, to adopt procedures and designs measures that correctly estimate the non permissible income for each company in the portfolio, and how much such income constitutes out of the investment earnings of each subscriber.

How to estimate the "usurious" income:

The funds portfolio consists of tens of companies each having the probability of interest earning. However, the investor will not be receiving income directly from any company. Rather, he will receive income from the investment company. i.e. the fund. How would the manager then calculate the portion of each investors income that need to be purified.

There are many possibilities that differ significantly in terms of accuracy and practicality. It is important, however, that we know exactly what needs to be estimated. We want to know how much of the increase in the net asset value of the fund was coming from interest earning of the companies in the portfolio holdings. We, therefore start with each company and see what is the ratio of interest earning to the net revenue of that company. This percentage is totaled and divided by the number of companies to get the average. This average will then be applied to all the dividend income earned by the fund.

Why "net revenue" and not "net income" ?

One may wonder why did we apply the company's interest earnings to net revenue and not to net income. The reason is two fold: Firstly, because net income is not a very reliable variable. In a lot of cases, net income depends mere on company's accounting procedures that is reality. On the other hand revenue is not. Secondly, by relating interest earning to income, we assure that this part of company's revenue should not be charged with any operational expenses, which is not reasonable. interest earning is a revenue and therefore, it should be related to revenue items.

The process of cleansing then should include calculating interest earning as a percentage of net revenue for every company and then averaging out for the whole portfolio holdings. The result should be included in the cleansing formula that is advised to the subscribers in the fund.

I. <u>The Role of the Shari'ah Supervisory:</u>

To give assurance to subscribers about managers commitment to Shari'ah parameters, it is becoming customary that fund managers appoint a Shari'ah advisor (or advisors). Not all Islamic equity funds have Shari'ah advisors. Atypical Shari'ah advisors functions may be:

a- Provide opinion on matters referred to it from the manager relating to funds operations particularly initial screening and the cleansing process.

b- Issuing an annual declaration attesting to the managers adherence to the parameters set by the Shari'ah advisor and informing subscribers about the percentage of their annual income that they rid themselves of to cleanse their earnings.

Furthermore, a Shari'ah advisor is always a consultant. While may seek the opinion of the Shari'ah advisor on a continuing basis, he (or they) will never interfere in the day-to-day business of the fund. No Shari'ah advisor, for example, will be involved in the buy or sell orders of an equity fund, non in an "managerial" decision in its operations. He may voice his reservations on the managers decisions, but will never "pre empt" the manager.

THE SURPRISING PERFORMANCE OF THE ISLAMIC EQUITY FUNDS:

Whenever one mentions religious preference or social responsibility being part of investment parameters, the question in mind then becomes whether this means less income. Surprisingly enough all the equity funds whose portfolios are constructed alongside the Shari'ah restrictions, out-performed the bench mark, i.e. MSCI. One may say that equities in general did very well in the last few years. While this is correct, we still think that Islamic funds have an added advantage. The selection criteria actually picks up superior quality companies. In particular, restrictions on the indebtedness of the companies in the portfolio turns out to be very significant screen.