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Islamic equity funds

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ISLAMIC finance signifies financial services, mechanisms, practices, transactions and instruments that comply with provisions given in the fundamental Islamic texts. Thus, Islamic finance not only includes banking, but also capital formation, capital markets and all types of financial intermediation.

In recent years, Islamic finance has not only increased in size. It has also become complex as finance professionals compete furiously to produce new Sharia-compliant transactions and instruments. Becoming a segment within the global financial market, it has gained considerable interest as an alternative model of financial intermediation.

However, in the 1980s and most of the 1990s, Islamic finance did not have much of this dynamism. On the asset side, the activities of Islamic financial institutions mainly involved ijara, mudaraba and musharaka. The need for liquidity, portfolio and risk management tools, and derivative instruments was strongly felt, and there were numerous calls for the promotion of financial engineering and the introduction of new products.

Along with other developments, this resulted in the introduction of Islamic equity funds (IEFs). Overall, IEFs have been the most popular among all Islamic investment funds. According to FTSE, IEF assets are forecasted to increase from $15.5bn to $53.8bn by 2010. According to other reports, the assets have already reached $20bn.

The industry is dominated by Saudi Arabian funds and fund managers, accounting for more than 70 funds out of about 300 IEFs globally. In fact, Saudi British Bank’s Amanah GCC Equity Fund was reported as the best performing Islamic equity fund in 2007. On the other hand, Bahrain is becoming the centre for IEF registrations because of the kingdom’s efficient regulatory system. International investment firms with Islamic divisions are focusing on Dubai.

IEFs are different from conventional equity funds because they select their placements on the basis of their compatibility with the Sharia. In order for a stock to be considered Sharia-approved, it must satisfy certain requirements set by Islamic scholars. These standards may differ in different jurisdictions depending upon how strictly the Sharia is interpreted.

However, the basic condition is the same throughout the Muslim world: an enterprise must not conduct business activities prohibited by Islamic texts. These include gambling, alcohol, pornography, etc. Financial ratios (debt-to-equity ratio, cash and interest-bearing securities-to-equity ratio and cash-to-asset ratio) and cleansing mechanisms (to purify investments that are tainted by forbidden activities) are also used by various Sharia boards and authorities.

It must be mentioned that a country may or may not have a national screening body. For instance, in Malaysia, it is done by the Securities Commission; whereas in the Middle East financial institutions prepare their own list of Sharia-approved stocks.

One of the factors that gave an immense boost to IEFs was the introduction of the Dow Jones Islamic Market Index (DJIM) in 1999 as a subset of Dow Jones Global Indexes (DJGI). DJIM Indexes intend to measure investable equities that fulfill Sharia requirements. At present, with more than 70 Islamic indexes (which include regional, country, industry and market-cap-based indexes), it is one of the most comprehensive families of Islamic market indexes.

Other conventional index providers have also entered the field. In 2000, FTSE launched the FTSE Global Islamic Index. Unlike Dow Jones that has an independent Sharia Supervisory Board, FTSE indexes are evaluated by Yasaar Research Inc. In 2006, Standard & Poor's (S&P) introduced the S&P Sharia Indices, followed by in 2007 the S&P GCC Sharia Indices and the S&P Pan Asia Sharia Indices. S&P has contracted with Ratings Intelligence Partners (RI) to provide the Sharia screens and select the stocks based on these standards.

As reported by the Financial Times, these indexes do not enjoy complete acceptance by Muslims. The screening principle allowing total debt ratios of up to 33 per cent is considered objectionable by some scholars. They claim that it is akin to declaring a kind of food that has a small quantity of pork in it as halal. The indexes maintain that their legitimacy comes from the concerned Sharia authorities. In other words, as long as their Sharia supervisors agree with these practices, the indexes need not change them.

The future of IEFs does not look gloomy at all. However, Muslim scholars need to be careful while interpreting and applying the Sharia. They need to make sure that Islamic principles are properly observed and that they don't present or accept an un-Islamic idea as Islamic just because there is more profit in it.