

Islamic Mutual Funds: How Do They Compare with Other Religiously - Based and Ethically - Based Mutual Funds?

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ABSTRACT

Islamic Mutual Funds are designed to meet the constraints imposed by Islamic Shariah. This paper compares the components and characteristics of Islamic mutual funds, Christian mutual funds, both classified as Morally Responsible Investment (MRI) funds, and Socially Responsible Investment (SRI) funds. The paper explores the possibility of designing a mutual fund which can satisfy the three different groups of investors.

I. Introduction:

We are investigating the extent of overlap between the objectives and components of Christian funds, Islamic funds, both classified as faith-based funds or Morally Responsible Investment (MRI) funds, as well as the related category of Socially Responsible Investment (SRI) funds, also known as “Green Funds” or “Ethical Funds”.

Faith-based funds invest in companies whose products and policies are consistent with investor’s religious (usually moral) beliefs, whereas SRI funds invest in companies based on social values. The amount of money invested in SRI funds is \$2 trillion^{1,2}, the size of the Islamic finance market is estimated at \$300 billion³, however there are no available statistics on the money invested in Christian funds. In the USA, it is estimated that \$1 in every \$7 is being invested according to some social criteria⁴.

The number of Islamic funds in the world in 2004 was estimated to be 130⁵, the number of Christian funds in the USA was less than 24 in 2005⁴, whereas the number of SRI funds in the USA was 200 in 2003².

We would like to explore the possibility of a mutual fund that encompasses all three objectives.

II. Definition of a mutual fund:

Mutual funds are investment companies which pool money from investors who share a common objective. The money is then invested by professional managers in the stocks and/or bonds of different companies, thus giving investors the three benefits of professional management, diversification, and liquidity. In the USA there are hundreds of financial companies which offer investors a very wide and sometimes confusing selection of mutual funds. The objectives range from growth, income, international diversification, technology, healthcare, commodities, faith-based, socially responsible investing (SRI) etc.. Today in the USA it is estimated that the mutual fund industry has grown to approximately **\$7 trillion**.

III. Islamic Mutual Funds:

III(A) A Description of Islamic Mutual Funds:

Muslims represent about one fifth of the world’s population. It is estimated that the size of the Islamic finance market is about \$300 billion³.

There are currently around 7 million muslims in the USA. Various money management companies in the USA, in the Middle East, and around the world, have recently started developing products which aim to meet the needs of this niche market, by developing funds which abide by Shariah (Islamic principles of living). Examples include Citibank, Barclays Capital, Morgan Stanley, and HSBC.

One of the most distinct features of Islamic finance and investment is the prohibition of Riba (the earning or charging of interest). Islam focuses instead on partnerships and risk-sharing. Another distinct feature is the fact that investments in bonds or

preferred stocks are not allowed because both promise a fixed rate of return and because in Islam all shareholders should be on an equal footing.

The term Islamic funds is a **misnomer**, it might be mis-interpreted as funds which invest in Islamic companies, when it really means companies whose activities are “**halal**” (lawful) not “**haram**” (unlawful), and thus are not objectionable under Shariah “Islamic law”. Some have suggested a more meaningful name for Islamic funds which is “Shariah compliant funds”⁶.

Islamic funds have been established by both muslim and non-muslim players, in the USA, the Middle East, and elsewhere. Worldwide, Islamic funds have grown from 41 funds (1997) to 102(2000) to 108(2003), to 130 (2004)⁵, which means that the growth rate has slowed down.

III(B) Who sets the Screening Guidelines for Islamic Funds?

One problem with Islamic Funds is that there is no perfect agreement on the interpretation of Shariah, this could be resolved by establishing a globally recognized Shariah Advisory Board For Islamic Finance/Banking/Investing, which would have the last say on all matters⁶.

It appears that most funds have internal boards which are responsible for establishing the screening guidelines. The Dow Jones Islamic Indexes, which will be introduced below, have a Supervisory board of Islamic Scholars which provides advice on compliance and eligibility of companies, the scholars currently are from the USA, Syria, Malaysia, Pakistan, Bahrain, and Saudi Arabia⁷.

III(C) Screening Standards (Criteria) for Islamic Funds:

Companies which are objectionable in Islamic Funds are the majority of financial institutions which are involved in money-lending and interest, such as banks and insurance companies. Other screening criteria which are similar to those applied by Christian and SRI funds represent objections to companies which are involved in production /distribution / and/or profiting from alcohol, porn, tobacco, gambling, weapons, music, entertainment, processing pork meat or non-halal meat, hotels and airlines which serve alcohol on their premises.

In addition, restrictions are applied to certain ratios, thus the Dow Jones Islamic Market Indices (DJIMI) apply the following screens to companies which pass the initial test⁷

- *“Total debt divided by trailing 12-month average market capitalization must be less than 33%.*
- *The sum of company's cash and interest-bearing securities divided by the trailing 12-month average market capitalization must be less than 33%.*
- *Accounts receivable divided by the trailing 12-month average market capitalization must be less than 45%.”*

Some funds lower the restrictions on non-halal activities, and permit investing in companies which have <5% of their revenues from non-halal activities, with the condition that any profits from such activities should be given to Islamic charities, a process known as “**portfolio purification**”.

Typical Islamic fund holdings are technology, telecom, steel, engineering, transportation, health care, utilities, construction, as well as real estate .

III(D) Benchmarks for Islamic Funds:

The Dow Jones Islamic Market Indices (DJIMI) ⁸ are currently used as yard sticks in evaluating the performance of Islamic funds of the appropriate category. The first index DJIMI was launched in february of 1999, it screened companies in 34 countries, and it had 1318 companies in July of 2003. Today there are about 50 DJ Islamic indexes they vary by size, industry, and region. There are currently 95 Islamic mutual funds which track the DJ Islamic indexes ⁹ .

Because DJIM component data is available to licensees only, we present below the top 10 holdings of a Dow Jones Islamic/K mutual fund, ticker symbol IMANX:

Top 10 Holdings (6/30/05)	
Dow Jones Islamic/K mutual fund , Source: S&P500 Netadvantage	(%)
Exxon Mobil Corp	6.41
Microsoft Corp	3.76
Pfizer Inc	3.64
Johnson & Johnson	3.26
Intel Corp	2.77
Procter & Gamble Co	2.38
Cisco Sys Inc	2.28
Chevron Corp New	2.11
IBM Corp	2.05
PepsiCo Inc	1.58
Total	30.24

Table 1: **Top 10 Holdings (6/30/05)**
Of Dow Jones Islamic/K mutual fund

In this table we note the heavy investment in technology, energy, health, and consumer products. On the other hand there are **no financial companies** amongst the top-10- holdings

IV. Socially Responsible Investment (SRI) Mutual Funds

IV(A) A Description of SRI Mutual Funds

SRI funds aim *“to integrate personal, social, and environmental concerns with financial considerations , their objective is to increase investors’ wealth while ensuring that the selected companies have a positive impact on people and the planet”*¹⁰.

The first socially responsible mutual fund was established in 1971. According to J. Clements *“the amount of money invested in SRI funds has gone up 137% since the end of 2000, compared to the 24% asset growth for all stock and bond mutual funds”*.¹¹ This is compared to an expected growth rate of 15% for Islamic financial markets⁹.

IV(B) Screening Guidelines of SRI Mutual Funds

The Social Investment Forum (SIF)¹² appears to be the most influential in setting the guidelines for SRI investments. It is a national nonprofit trade association whose mission is to promote the *“concept, practice, and growth”* of investing which is socially and environmentally responsible.

SIF includes *“over 500 social investment practitioners and institutions, including financial professionals, analysts, portfolio managers, banks, mutual funds, researchers, foundations, community development organizations, and public educators.”*¹²

IV(C) Screening Standards (Criteria) for SRI Mutual Funds

The following is an example of an **SRI** list of screening criteria:
Companies which are selected for investments have to pass the following tests:

- No involvement in alcohol, gambling, tobacco, weapons production or distribution.
- Showing respect and good performance in the areas of animal welfare, board diversity, community relations, corporate governance, environment, human rights, indigeneous peoples rights, product safety and impact, and workplace practices.

The last 3 lines were underlined to distinguish SRI from most MRI mutual funds.

IV(D) Benchmarks of SRI Mutual Funds

KLD's Domini 400 SocialSM Index, which was modeled on the S&P 500 index, is a socially screened, value-weighted index of 400 common stocks, it was created in May 1990¹³. It could be used in evaluating an SRI fund that invests in large USA companies.

Top 10 Holdings as of September 30, 2005

The KLD Domini 400 Socialism Index (DS 400 Index)¹³

“KLD created the DS 400 Index by screening the S&P 500 and adding additional companies. The index includes 400 companies at all times”

1. Microsoft Corporation *
2. Johnson & Johnson*
3. American International Group, Inc.
4. Intel Corporation*
5. Procter & Gamble Company*
6. J.P. Morgan Chase & Co.
7. Cisco Systems, Inc.*
8. Wells Fargo & Company
9. Amgen Inc.
10. PepsiCo, Inc.*

Table 2: **Top 10 Holdings as of September 30, 2005**

The KLD Domini 400 Socialism Index (DS 400 Index)

The * indicates a company that is also a top 10 holding in the Dow Jones Islamic/K fund, in table 1

- Another possible benchmark is the **Calvert Social Index** which is “a broad-based, rigorously constructed benchmark for measuring the performance of large, US-based socially responsible companies.”¹⁰
- Yet a third one is the **Dow Jones Sustainability Index, DJSI** which screens companies through an assessment of corporate economic, environmental and social performance⁸.
- One could also use a recently created benchmark which is the **Vanguard Socially responsible Calvert index fund**.

We notice the prevalence of technology companies, health related companies, consumer products, and most importantly the presence of **three financial companies, in contrast with the Islamic index** discussed above. We also notice the absence of energy companies such as Exxon or Chevron.

However, the Dow Jones Islamic/K mutual fund and DS400 SRI index have **6 out of 10** top holdings **in common**.

V Christian Funds:

V(A) A Description of Christian Mutual Funds

Christian funds end up being lumped together with the broader category of SRI funds, thus it is difficult to find a lot of unique information about them.

There are various funds which cater to different denominations, such as Roman Catholic, Lutheran, and Christian Scientist. In general, the various Christian mutual funds have a lot in common. We will focus on **Catholic** funds in this study.

V(B) Screening Guidelines for Christian Funds:

As an example of a source of screening guidelines we mention The United States Conference of Catholic Bishops "USCCB" which is a Catholic organization, that follows the teachings of the Gospel, the Church, and the USCCB Conference when making investment decisions ¹⁴.

V(C) Screening Standards(Criteria) for Christian Funds:

USCCB summarizes its screening standards by the following principles:

"Do no harm (avoid evil), Active Corporate Participation, Positive Strategies (Promote the Common Good)" ¹⁴.

Christian funds in general do not invest in the stocks or bonds of companies that are involved either directly or indirectly in abortion, contraceptives, family planning, pornography, anti-family entertainment, alternative lifestyles, as well as those directly involved in the production of alcohol, tobacco or gambling, fire arms, nuclear power.

V(D) Benchmarks for Christian Funds:

We recently came across a benchmark for Catholic funds after reading an article in the most recent issue of JOI. The title of the article is "The KLD Catholic Values 400 Index", by L. Kurtz and D. Dibartolomeo, JOI, Fall 2005, pg 101-104 ¹⁵

The KLD CV 400 Index, modeled on KLD's Domini Social 400 Index, which was discussed above, is a market-capitalization weighted index. It tracks the performance of 400 U.S. corporations that pass social, environmental, and KLD's **Catholic values screens**.

*"The KLD CV 400 Index is composed of approximately 250 S&P 500[®]; 100 mid-cap companies for industry representation and 50 small-cap companies with exceptional social stories. Companies involved in alcohol, firearms, gambling, military, nuclear power, tobacco and abortion are excluded from the Index."*¹³

It turns out that DS 400 and CV 400 have the same exact top 10 holdings and the only difference between the two indexes is 4 companies which are involved in abortion and thus were deleted from the CV 400 Catholic Index. **After questioning the KLD Research Analytics staff about this , we were told that they are currently working on constructing a better Catholic Benchmark**, this confirms our earlier belief that Christian funds are often lumped together with SRI funds.

VI Shareholder Advocacy or Activism

SRI and Christian funds sometimes allow investments in some of the objectionable companies with the hope that being part-owners will help them to influence corporate behaviour. An example would be investing in the stock of General Motors and filing shareholder resolutions which put pressure on the company to reduce auto emissions by its fleets. This is referred to as “**Shareholder Activism**”.

VII Performance of MRI and SRI Funds

Performance here refers to the return, risk, and cost of running the funds.

Should we expect MRI and SRI funds to outperform conventional funds?

VII(A) *Factors which would contribute positively to performance:*

- Large companies are usually well-diversified, which means that they are more likely to “get in trouble” by having subsidiaries in objectionable sectors. Hence smaller companies are more likely to pass the MRI and SRI screening tests. Historically smaller companies were found to be more risky, and generated higher returns. We need to look at the risk-adjusted returns of those mutual funds.
- Investors in MRI and SRI funds are known to have an “**unflinching commitment**”¹¹, which leads to them having a long-term investment horizon. This should give the funds stability and possibly a higher risk-adjusted return.
- Companies which have less debt (Islamic funds), usually are less risky and may be more profitable. In addition, corporations which pass the ethics screens (MRI and SRI funds) generally have a better image, and thus are likely to perform well.
- MRI and SRI investors and managers generally trade and speculate less often, and thus those funds have a lower turnover rate, which should result in lower expenses¹⁶.

VII(B) *Factors which would contribute negatively to performance:*

- The restricted investment universe may lead to lower diversification levels, especially with elimination of complete industries such as finance or alcohol, this would result in a higher company-specific risk without a compensating higher return.
- It is a common belief that MRI and SRI funds generally have slightly higher expenses than comparable plain-vanilla conventional funds in the same category. This is due to the fact that more research is needed to screen companies, and to continuously monitor them for compliance with the screening guidelines.

- In addition, the smaller size of assets should result in a higher expense ratio, defined as total expenses divided by total assets.

Thus we cannot make a generalization, the performance depends on each individual fund.

VIII Literature Survey of Performance

Next we survey the literature for concluding information about the performance of Islamic funds and SRI funds.

VIII(A) Islamic Funds' Performance:

- Technology companies are among the largest holdings in Islamic funds, because so far they have relied on very little debt for their financing. The fact that Islam forbids the earning or charging of interest makes Islamic funds negatively correlated with the financial sector and positively correlated with the technology sector.
- Khaled and Mohammed ⁹ examined the time period 1996-2003, they divided it into two subperiods, (January 1996-March 2000, classified as a Bull Market) and (April 2000-July 2003, classified as a Bear Market). Those authors raised the question whether technology companies were mostly responsible for DJIMI's over-performance during the Bull period. Their research shows that Islamic funds provide abnormal returns, which are not caused by the tech sector. They summarized the DJIMI performance as follows:

Bull market: DJ Islamic indexes on avg outperformed similar indexes, because they avoid high debt companies. Examples of success stories: Enron, Tyco, and Worldcom were kicked out of or not allowed into DJIMI which spared the shareholders huge losses.

Bear mkt: Islamic indexes underperformed similar indexes, possibly because the alcoholic industry which is a defensive industry does best during bear markets.

Average Return: Khaled and Mohamad found that the average return for both types of markets was greater than similar indexes. A summary is presented in Table 3.

Are Islamic funds attractive to the average investor?

Islamic funds are relatively few in number. In general they are heavily invested in healthcare, info tech, and consumer products, consequently they end up looking a lot like conventional funds of the same objective and style, with sometimes higher expenses as a disadvantage. In addition, some of these funds limit their investments to their domestic markets which results in a loss of diversification and a higher company-specific risk without a compensating higher return.

VIII(B) SRI Funds' Performance

Since we did not find a Christian benchmark that is clearly distinct from SRI benchmarks, we focus on SRI funds in this section.

- According to KLD Research Analytics¹³, since its inception in May 1990, the Domini Social 400 Index outperformed the S&P 500 on a total return basis and on a risk-adjusted basis, see Table 3.
- According to Clements¹¹, “SRI funds returned an annual 9.1% on average over the past decade, compared to 9.4% for all U.S stock funds”
- Morningstar, which is a Chicago-based fund-rating company, uses a star rating system which is based on return, risk, and cost metrics, with 5 stars being the best. According to the 2003 Report on SRI Trends in the United States², during the period 2001 to 2003, Morningstar gave a rating of four or five stars to only 32.5 percent of the universe of mutual funds that it tracks. The percentage of SRI funds which have repeatedly received four or five star ratings was higher than 32.5%.
- 103 SRI funds in Germany, USA, and the UK, were studied by Bauer et al¹⁷ who found the risk-adjusted returns to be comparable to conventional mutual funds.
- Several studies of SRI expense ratios were done. One study found that they are “neither more nor less costly than other funds of a similar type”². However, other authors looked at a sample of funds, and found that SRI investors paid an average expense ratio (management and operating expenses) of 1.33% , which is slightly higher than the average expense ratio of 1.10% for non-SRI funds in the sample¹⁶.

Table 3 : A comparison of the rates of return between The Dow Jones Islamic (US) Index, the KLD Domini Social 400 Index, and the S&P500 Index. All contain large USA companies.

Total Return as of 09/30/05	DJI(US) ⁸	KLD DS400 ¹³	S&P 500
One Year	13.27%	9.69%	12.25%
Three Year	15.66%	15.76%	16.72%
Five Year	-6.09%	-1.69%	-1.48%
Ten Year	-	9.97%	9.50%

IX Final Comments:

- Our study shows that Islamic, Christian, and SRI funds have a lot in common. The screening criteria are similar. What distinguishes Islamic Funds the most is their objection for interest income/expense, the requirement of certain financial ratio standards, and the objection to pork and music companies. However, Islamic funds should have no problems with the screening criteria of Christian and SRI funds such as screening for abortion, good labor relations, and so on.
- Christian funds and SRI funds may see no point/need for screening out pork-processing and music companies, although some fund managers might approve of the idea of screening out high-debt companies.
- We suspect that a mutual fund that uses all 16 screens would result in a very small universe of companies to choose from, however, it might be worth investigating.
- We recommend constructing a portfolio “fund of funds” which contains the three types of funds: Islamic, Christian and SRI for those investors who are open-minded and who want to **“DO WELL while DOING GOOD”**. However, the downside is that there might be lot of overlap among the holdings!!!

X A Comparison of the Screening Standards of MRI and SRI Funds

In Table 4 we use the notation adopted by Social Investment Forum (SIF)¹, to compare Islamic, Christian, and SRI fund screening criteria.

“X=No Investment:

The fund will not knowingly invest in any companies with certain specific practices or policies in this issue area.

P= Positive Investment:

The fund seeks to invest in companies with a positive records in this area.

R= Restricted Investment:

The fund has certain parameters on investing relative to this issue. One common limitation allows the fund to only invest up to a set percentage of its invested assets in companies with certain practices or policies..

NS= No Screens:

The fund has no specific screening policies or practices in this issue area”.

KEY¹:

X No Investment

P Positive Investment

R Restricted Investment

NS No Screens

Company’s Product or Service	Islamic⁷ Mutual Funds	Christian¹⁴ Mutual Funds	SRI¹ Mutual Funds
Interest & High % of Receivables	R	NS	NS
Pork and non-Halal Meat	X	NS	NS
Alcohol	X	X	X
Gambling	X	X	X
Tobacco	X	X	X
Anti-Family entertainment	X	X	X
Music	X	NS	NS
Defense Weapons	X	X	X
Abortion	NS	X	X
Nuclear Power	NS	X	X
Alternative Life Styles	NS	X	P
Labor Relations	NS	NS	P
Corporate Governance	NS	NS	P
Human Rights	NS	NS	P
Employment/Equality	NS	NS	P
Community Investment	NS	NS	P

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