Shariah and Socially Responsible Investment (SRIs) in the US:

Are Investors in these Portfolios Disadvantaged?

By:

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In recent years, there has been a notable increase in investor consideration for religiosity and/or ethics in investment decisions making it a class of investments in its own right and an important input in portfolio selection decisions. Investment decisions are governed not only by factors including investor anticipation of future economic, geo-political trends, social changes and investment timing but also religion or belief system. The religiosity and/or ethical practices prompt investors to discard so-called 'sin stocks' and limit their investment horizons to permissible investment alternatives. These faith-based investments have emerged in two prominent forms, namely Islamic or Shariah-based investments and Socially Responsible Investments (SRI). For the Shariah-screened portfolios, the class of assets and the securities in each selected class are subject to Shariah requirements. These requirements prohibit charging interest on loans, gambling and trade of impermissible items like liquor, pork and other Islamically prohibited items, and also imposes restrictions on the level of debts in financing and investment.

The history of SRI or ethical investing dates back to the start of the twentieth century[1]. Ethical investors are motivated by social, environmental, and ethical considerations in their investment decisions. They apply a set of investment screens to include or exclude assets based on ecological, social, corporate governance or ethical criteria. The growing importance of faith-based investments can be judged by the significant increase in the overall industry size. The Islamic finance industry has observed a double digit compound annual growth rate (CAGR) of 17% between 2009 and 2013 and the size of industry is still expanding both in terms of numbers and geographical locations[2]. In the same manner, the volume of assets acquired through socially responsible investing strategies stood at 8.72 trillion USD in 2016 and the number is expected to further increase in coming years[3]. There is potential for further growth for these faith and ethical based investments, since religious or ethical values are becoming a matter of concern to most investors. This is true, even if they have to trade-off with lower risk-adjusted returns compared to returns on conventional investments with similar risk.

Faith-based investment styles create several challenges for investment managers. To begin with, the universe of stocks for faith-based portfolios is restricted. Hence, it is probable that these portfolios may underperform as many attractive investment opportunities will be forgone due to religious or ethical restrictions. The literature on performance of faith-based portfolios is inconclusive. It is therefore pertinent to identify whether ethical and religious beliefs lead investors to bear additional costs. This article summarizes the findings on a comparative study of risk and returns of Shariah compliant and SRI firms in the US. Three portfolios of stocks were analysed:

A portfolio of Shariah compliant stocks,
A portfolio of Socially Responsible Investments (SRI) stocks, and
The market proxy portfolio comprising of market representative stocks.

The (possible) variance in idiosyncratic risk and performance patterns among the investment classes were for between 2006 and 2015, to allow evaluation of the risk-return trade-off for crisis and non-crisis periods. To estimate idiosyncratic risk and risk-adjusted return performance, three different 'factor models' were applied, namely the Capital Asset Pricing Model (CAPM), Fama-French Model (FF3) and Carhart (CRH4) Model. The portfolios were formed using i) Equally Weighted Portfolio Strategy, giving equal weightage to

[1] Responsible Investing Hurt Investment Retunns? Available at: http://funds.rbcgam.com/_assets-custom/pdf/RBC-GAM-does-SRI-hurt-investment-returns.pdf.

[2] IFSB (2015) Islamic Financial Services Industry Stability Report 2015: IslamicFinancial Services Board. Available at: http://www.ifsb.org/docs/IFSB%20Islamic%20Financial%20Services%20Industry%20Stability%20Report%202015_final.pdf.

[3] USSIF (2016) Report on US Sustainable, Responsible and Impact Investing Trends, Washington: US SIF Foundation. Avaailable at: http://www.ussif.org/content.asp?contentid=40.

every stock irrespective of its market capitalization and resulting in higher portfolio volatility owing to the higher representation of small cap stocks that are considered riskier and ii) Capitalization Weighted Portfolio Strategy, giving representation to stocks with respect to their market size and expected to be lesser volatile due to their higher representation of more seasoned companies.

The results revealed some important insights. It had been observed that for equally weighted portfolios, idiosyncratic risk was observed for all the portfolios. All three portfolios had positive alphas, implying that they performed better than the market. The Shariah portfolio recorded lowest unsystematic risk and lowest risk-adjusted return. The sample portfolios possessed higher-than-market systematic risk which was compensated by positive alphas, and small stocks provided the primary source of return for all the three portfolios. The returns for market and SRI portfolios were generated from large and seasoned firms (value bias) whereas the returns for the Shariah portfolio were largely from growing companies (growth bias). The momentum factor coefficient showed that the positive alpha was not the result of the momentum strategy i.e. buying past year winners and selling past year losers.

For capitalization-weighted portfolios, all the portfolios had negligible idiosyncratic risk but negative Jensen's alpha implying that they underperformed the market. There was a very small difference in the magnitude of Jensen's alpha for the sample portfolios. The market beta for these portfolios was lower than market, and justified their negative alphas. The size premium was positive for market and SRI portfolios, implying that the return for these portfolios came from small capitalization stocks whilst it was negative for the Shariah portfolio, implying that the return for this portfolio was mainly earned from large capitalization stocks. The values versus growth premiums were negative, implying that the returns were mainly from large and seasoned companies. Finally, the momentum factor was negative and very low, implying that no momentum strategy was meaningful. In summary, it was revealed that for both equally-weighted and value-weighted portfolios, the performance of the Shariah portfolio was inferior to the other two portfolios.

The findings provide some insights to the literature on the investment industry in the US. Shariah compliant firms recorded higher systematic risk possibly owing to their suboptimal capital structure. The faith-based investment style seems to be disadvantaged, though remaining viable in the long run. For capitalization-weighted portfolios, investors holding screened (religious or social beliefs) portfolios earned equal risk-adjusted returns, but were exposed to higher market risk. Hence, the faith-based investors who want to design their respective portfolios to achieve diversification and earn risk-adjusted returns at par with market should be prepared for higher market risk when investing in value-weighted portfolios.

Finally, it appears that unlike popular argument that Islamic finance can offer alternatives to non-Muslim investors seeking ethical investment avenues, SRI investors in the US seeking investment in Shariah portfolios as an alternative to SRI investment will bear increased cost in the form of higher systematic risk.