

Investment Practices for Islamic Mutual Funds within the Saudi Arabian Capital Market

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Abstract

The burgeoning Islamic asset management industry has recently received widespread coverage on the financial and investment sectors. It has contributed tremendously to the current interest among investment houses, small and large corporations, managed funds, and private investors in this extremely viable and lucrative alternative to conventional investment endeavors. The Gulf Cooperation Council (GCC) region has, in particular, stood out as a strong and stable economic platform to increase and generate funds. Major world events notwithstanding, a formidable financial services sector is fast emerging there. Having become a world-leading financial center and major trading hub linking east and west, Saudi Arabia is one of the world's most favored investment landscapes at the moment. (WorldFinance.com, 2016)

This purpose of this study is to examine the reasons for this monumental rise, and highlight the key sectors where Saudi Arabia is serving as an example for other Islamic financial and economic systems. Islamic mutual fund is the focus on which the study is built. One important portfolio lesson from this case study is that Islamic mutual funds (or IMFs) offer hedging opportunities for investors during economic downturns because of the restrictions that Islamic law imposes on portfolio selection (Hesham et al., 2010). This is due to a combination of superior stock selection ability of IMFs and the negative market timing ability of conventional funds. All investors, regardless of ethical or religious orientation, can enjoy the benefit of hedging by holding a proportion of investment portfolio in IMFs, within the context of the Saudi Arabian capital market (Ashraf, 2013)

Keywords: Islamic Laws; Mutual Funds; Saudi Arabia; Capital Markets

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Introduction

Socially responsible investing has evolved significantly over the past few decades. Perhaps nowhere has it found greater expression than in Islamic finance. The confluence of wealth and faith in the Muslim world has fueled a demand for Sharia-compliant products. Investment management firms with a global reach, as well as portfolio managers and their analysts are realizing that trading in these products is critical to their business models.(Canepa and Ibnrubbian, 2014) Over the past quarter century, investment in ethical equity mutual funds whether based on social responsibility principles, environmental considerations, good corporate governance, engagement in local communities or, adherence to religious beliefs (Islamic, Jewish or Christian) have grown considerably around the world. In the US alone, funds under professional management following ethical screening increased from US\$2.71 trillion in 2007, to US\$ 3.07 trillion in 2010, (US SIF, 2010). Globally, assets under management (AUM) of IMFs represent less than one percent of the USD 25.92 trillion global mutual funds market. The AUM of IMFs have grown from USD 3.3 billion in 2003, to USD 58 billion in 2010 (Ernst & Young, 2011). The IMF market is also growing rapidly across both developed and under-developed capital markets, with more than 700 mutual funds currently offered globally. These funds specialize in diverse asset classes including equities, commodities, fixed income and money markets.

Islamic Mutual Funds

Mutual funds provide opportunities for better diversification and professional management expertise to small investors at a lower cost. Empirical studies show that Islamic indexes have normally distributed efficient returns just as conventional indexes do. Moreover, because of the noncompliance filtering, Islamic indexes have developed some unique risk-return

characteristics that are not affected by the broad equity markets. Islamic mutual funds' behavior relative to conventional mutual funds' is inconclusive. Conventional mutual funds pool money from small investors and invest in a variety of securities, including stocks, fixed income, real estate and commodities. Islamic mutual funds (or IMFs) are very similar to conventional funds. The exception is that securities held in an IMF have to comply with the Islamic jurisprudence rules. An IMF can screen out all of those securities that do not satisfy Shariah standards.

Given the fact that IMFs investments are subject to Shariah constraints, their holdings differ from those of conventional funds. Therefore, Islamic benchmark indexes constructed based on Shariah principles, are more appropriate in explaining the return variation of IMFs compared to conventional indexes.

Managers of IMFs exhibit better security selection than managers of conventional funds. In addition, managers of IMFs, on average, do not have any superior market timing capability during the sample period. In contrast, managers of conventional funds not only exhibit poor stock selection ability but also exhibit significant negative market timing ability. Abderrezak (2008) suggests that ethical-based mutual funds underperform compared with conventional funds due to lower diversification and missed investment opportunities. However, such funds may outperform conventional funds in the longer term due to lower volatility, lower cash outflows (especially during recessions), and investors' commitment to the funds. Hoepner et al. (2011) suggest that IMFs perform better than conventional funds especially in the economic downturn due to the absence of leverage from securities that these funds hold. They compared the performance of IMFs across different countries and suggest that IMFs from countries with a majority of Muslim population neither underperform their equity market benchmarks nor experience a small cap bias.

Saudi Arabia as an Emerging Investment Market

At a time when the GCC region is enjoying unprecedented oil revenues, which may reach \$9 trillion by 2020, Islamic asset management will only become more significant on the world stage. The Gulf Cooperation Council's mutual fund industry is rapidly growing. In 2006, the size of that industry was \$56.69 billion with 402 listed funds. The industry grew to \$160 billion in 2010, and \$300 billion in 2015. (Ashraf, 2013) Even though the industry is still in its early growth stages, an Ernst & Young (2008) report outlines many of the ways in which market participants can prepare themselves to take full benefit of this sector as it matures.

The report further highlights continued economic growth across key markets and the resultant increase in liquidity held by major investor segments. It details demand-supply considerations across these investor segments and across geographical markets, before offering conclusions on existing and predicted gaps in Sharia-compliant products and service offerings. The report examines key strategic risks currently affecting the Islamic asset management industry and mitigating strategies being adopted by market leaders.

Saudi Arabia's economy and stock market are the largest in the Middle East. The largest crude oil producer's product markets are blessed with high liquidity and strong purchasing power and steady growth. Saudi Arabia constitutes more than 20% of the global Islamic capital market, and is also the biggest market for IMFs. The Saudi Arabian stock exchange is the largest amongst the Gulf Community Council (GCC) countries. More than 80% of mutual funds listed on Saudi Arabian stock market are Shariah-compliant funds. (Ashraf, 2013)

Shariah-compliant investment vehicles dominate the investment scene in Saudi Arabia, especially on the retail side. Saudi investors consider Shariah-compliant offerings as preferable. An Islamic offering is generally chosen over a conventional equivalent even if some return is

a forgone conclusion. Islamic products are considered essential for asset managers wishing to target investor segments in the Kingdom. Investment strategies in Saudi Arabia remain focused on equities.

The Saudi Investment Portfolio

Islamic mutual funds have been around for about a quarter of a century and are still in their infancy stage of growth and development (Girard and Hassan, 2005). Some Shariah-compliant mutual funds outperform their benchmarks and others underperform them. Therefore, there is no penalty for including Shariah-compliant funds in a portfolio. (Hesham et al., 2010)

In the late 1990s, IMFs became available in Saudi Arabia after the successful launch of IMFs in Malaysia and USA. Since its inception, IMFs have become increasingly popular among Muslim investors who would not invest in conventional mutual funds amid concerns that these funds would invest in stocks prohibited by Shariah principles. The popularity of IMFs raises the question, whether Saudi Arabian based IMFs, on average, provide better returns than conventional funds by exhibiting better stock selection and market timing abilities?

The Saudi Arabian Monetary Agency (SAMA) provides the regulatory guidance to the mutual funds industry in Saudi Arabia. These funds are managed by both local and international fund managers and offer a variety of asset classes for investments (e.g. equities, fixed income, real estate, foreign trade, commodities, money markets, etc). Both local and international fund managers offer conventional mutual funds, as well as IMFs. Individual investors in the country dominate what has been and continues to be a thinly traded market. There is little foreign investment, and institutional investors are more the exception than the rule. Therefore, the total investment pool of Saudi Arabia is much larger. Most high-net-worth and institutional

investors do not invest through mutual funds and generally take the route of professionally managed segregated accounts. No official numbers are available for this investment pool. However, it can safely be assumed to be much larger than the mutual funds market. (Hayat, 2013) Sectors in the Saudi market are few and are ranked by degree of adherence to religious practice. When evaluated, return distributions within and between these sectors display a greater positive relationship between risk and return for the more compliant funds. (Canepa and Ibnrubbian, 2014) Managers in the Saudi market follow the standard debt/market cap, noncompliant investment/market cap, noncompliant income/total income screens to arrive at the Shariah-compliant investable universe. Some managers/investors use total assets instead of market cap in the above-mentioned screening ratios.

The conventional investment products are mostly targeted towards institutional investors, some of which also prefer Shariah-compliant products. Consequently, fundraising in Shariah investment products has been more attractive for asset managers. With the underperformance of listed financial institutions in recent years, Shariah-compliant investment products have also done better than the conventional counterparts.

While split between Shariah-compliant and conventional professionally managed segregated accounts is not available, anecdotal evidence suggests a roughly 50/50 split. The mutual funds market is dominated by asset managers backed by commercial banks, as these were the early entrants to the markets. The top five players account for over 80% of the market share in the mutual funds space. These top five are: NCB Capital, SAMA Capital, Riyadh Capital, Al Rajhi Capital, and HSBC Saudi Arabia. In the segregated accounts market, Jadwa Investment is also considered one of the major investors; in addition to the big five. (Hayat, 2013)

Conclusion

The results for various studies conducted over risk-adjusted performance measures suggest that, in general, conventional funds outperform Islamic funds during overall and bull periods. However, in a financial crisis period, IMFs perform better than conventional ones, in the sense that they punish the investor less than conventional funds. Studies further indicate that IMFs show overall positive stock selection ability with the highest being in IMFs that invest in the Saudi Arabian equities. (Ashraf, 2013) The average excess return over benchmark is approximately 1.6% annually. On the other hand, conventional funds generally reflect a negative stock selection capability. The results on stock selection ability indicate that IMF managers possess superior stock selection ability than their conventional counterparts. This may be attributed to meticulous scrutiny of stocks by IMF managers due to their need to comply with Shari'ah principles. Consistency of performance, quality of service and strong relationship management are the key success factors for asset managers in Saudi Arabia.

Regardless of the benchmark used, the systematic risk for Islamic funds is always lower than their counterpart conventional funds during any financial crisis period. Thus, investors can include IMFs in their portfolios during a bear or a crisis period to help hedge the downside risk in such adverse economic conditions.

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