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The diversification benefits from Islamic investment during the financial turmoil: The case for the US-based equity investors[☆]

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Abstract

A major issue in both Islamic finance and conventional finance is whether the shocks to the volatilities in the asset returns are substitutes or complements in terms of taking risk. An understanding of how volatilities of and correlations between asset returns change over time including their directions (positive or negative) and size (stronger or weaker) is of crucial importance for both the domestic and international investors with a view to diversifying their portfolios for hedging against unforeseen risks.

This study is the first attempt to advance the frontier of knowledge particularly in the fast growing field of Islamic Finance through the application of the recently-developed Dynamic Multivariate GARCH approach. Our study is focused on investigating whether Islamic stock indices provide special avenue for the US-based investors.

Our findings based on the Dynamic Conditional Correlation (DCC) tend to suggest: both the conventional and Islamic MSCI indices of Japan, GCC ex-Saudi, Indonesia, Malaysia and Taiwan provide better diversification benefits compared to Korea, Hong Kong, China and Turkey. It tends to suggest that the Islamic countries provide better diversification benefits compared to the Far East countries with strong policy implications for the domestic and international investors in their portfolio diversification for hedging against unforeseen risks.

JEL classification: G11; G15; C58; F15; F21

Keywords: Dynamic Conditional Correlations; Multivariate GARCH; Conventional and Islamic stock

1. Introduction

Trade and financial liberalization since the late 20th century enhanced the process of globalization, with increased trade ties and economic synchronization, international stock market indices have become integrated. A decision by a country's government to permit foreigners to buy stocks in that country's stock market is called stock market liberalization (Henry, 2000). The rational behind financial liberalization is to restore growth and stability by raising saving and improving economic efficiency. Following the collapse of the Bretton Woods system, the developed countries initiated the international financial liberalization process.

Watson (1986) documented this development in terms of internationalization, securitization, and liberalization. In the

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case of internationalization, in the major industrial countries the speed of activity in financial markets has grown faster than real output, but this has been accompanied by even faster growth in offshore financial market activity. As far as securitization is concerned, there has been a move away from indirect finance, through intermediaries such as banking, to direct finance by means of international bond markets. Liberalization gave birth to the removal of domestic quantity and price controls, better international involvement in domestic financial markets, more cross-border capital flows, and, finally, new financial instruments (Kearney, 1996). As a result, business cycle synchronization and stock correlations are anticipated to rise over time and across countries.

The findings of low correlation among national stock returns in the early studies (Grubel, 1968; Levy & Sarnat, 1970; Solnik, 1974) suggest potential benefits of international diversification. However, recent studies have found evidence of asset market price correlation and contagion. For example, Goldstein and Michael (1993) documented that international linkages have been rising over the past decade, particularly for stocks transacted in the major financial centers of the world.

The highly cointegrated stock markets suggest that there are no diversification benefits since the performance and returns in these markets are highly correlated to each other. Basically, this idea encourages investors to diversify their assets across cross-borders, provided returns to stock in these other markets are less than perfectly correlated with the local market (Masih & Masih, 1997). The finance literature has already discussed the advantages of asset diversification, among them much effort was given to quantifying risk-reduction and its associated benefits available to the internationally diversified portfolio (Solnik, 1991).

From the stock market integration perspective, all assets with similar risk profiles and maturity have the potential to attract the same returns across different financial markets. Additionally, if there are no barriers such as country risk and exchange rate premium, financial assets of similar level of risk and liquidity are anticipated to gain similar yields, irrespective of location (Marashdeh & Shrestha, 2010; Narayan, Smith, & Nandha, 2004; Von Furstenberg & Jeon, 1989).

More recently, Rua and Nunes (2009), by utilizing wavelet coherency approach, found that since the end of the 1990s, the high degree of comovement has been extended to all frequencies. Prior to this date (end of the 1990s) the strong comovement was confined only to long-run fluctuations while after that date the comovement is visible for all sorts of short and long fluctuations. This finding indicates an additional input that there has been an overall rising comovement. Wang, Fang, and Ye (2013) demonstrated that the global financial integration between super-large-cap and small-cap stocks has increased in recent years. Their results also indicate that global market integration is primarily associated with the super-large-cap stocks of large emerging markets.

If the comovement is visible for both short and long-run, then the investors would know how to diversify their portfolios. Investors would be looking for different cross-border or asset classes such as ethical and Islamic investments, commodities, derivatives, real estate, and private equity/hedge funds, etc.

Most researchers have focused on the interdependencies of conventional stock indices and empirical works on Islamic stock indices are either not available or inconclusive. Given the conflicting conclusions of the research in this field, further highlights should be made available through an investigation of an alternative set of financial markets, particularly, a set of Islamic stock indices, at least, from an international diversification perspective. Islamic stock indices can most likely offer a far greater diversification potential for attracting global portfolios. Furthermore, investigations into the dynamic linkages of conventional and Islamic stock indices over time and across markets are of significant importance to investors and financial policy makers;

A related issue in order to help the investors get the diversification benefits is to investigate the comovements of the Islamic stock indices hitherto unexplored. The advocates of Islamic investment argue that the Islamic stock indices are better positioned due to the specific features of Islamic stock Indices such as, ethical and ratio screenings, exclusion of financial sectors, exclusion of highly leveraged firms, the limit of interest-based leverage, and, finally, exclusion of using complex and intensive structured financial products, derivatives, and other toxic assets. An Islamic stock index is argued to be more resilient to a financial crisis compared to a conventional stock index (Charles, Pop, & Darné, 2011; Sukmana & Kolid, 2012). The stocks in Islamic indices have been filtered according to debt-to-equity ratio (a certain upper limit, normally 33%) as well as removing the prohibited sectors. Generally, the application of the filtering criteria for Islamic indices is likely to result in higher concentration of some sectors such as industrials, technology, consumption services. It might be worth noting that trading cash as an asset is not allowed under Islamic rules. Therefore, only the financial sectors related to supportive activities (consultancy for example) are included in Islamic index. That may make the Islamic products less risky. However, we are aware that theoretically one could argue that although lower-leverage might make the Islamic products less risky, the smaller and less diversified universe and also an excessive exposure to sectors like housing might make the Islamic products more risky.

In other words, it is generally argued that the characteristics of the Islamic stocks are different compared to those of the conventional stocks in that the former entails a lower leverage, smaller size of firms and less diversified markets resulting in different risk-return portfolios. This requires an empirical investigation of the conventional and Islamic stock indices. Hence an important objective of this study is to investigate whether Islamic stock indices provide more diversification benefits compared with the conventional indices.

Despite the increasing attention and growth of Islamic investment, empirical studies on Islamic indices are scarce. In filling this gap, we investigate whether Islamic stock indices provide more diversification benefits relative to their conventional counterparts. Therefore, in this study, we investigate