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Should Islamic investors consider SRI criteria in their investment strategies?

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ABSTRACT

Can environmental, social and governance (ESG) performance be a criterion for Islamic investment policies? The development of socially responsible investments (SRI) challenges the conservative approach of Islamic investments toward promoting corporate social responsibility. This study therefore tests the potential of integrating positive ESG screening with Islamic portfolios using KLD social ratings, to determine the financial price that *shariah* compliance and social responsibility entail. Our results reveal no adverse effects on returns due to the application of Islamic and ESG screening; substantially higher performance results from the inclusion of good governance criteria in the post-subprime crisis period.

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1. Introduction

In the past 20 years, socially responsible investing (SRI) has increasingly attracted the interest of individual and private investors, as well as academics. Unlike conventional investments, SRIs entail a set of screening methods that exclude or include stocks on the basis of environmental, social and corporate governance (ESG) criteria, often with the engagement of local communities and active shareholders who encourage relevant corporate strategies (Renneboog et al., 2008). More recently,

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another form of ethical investment, Islamic investment, focuses the interest of academics and practitioners. An Islamic investment policy instead conforms with the *shariah* guidelines and principles that govern all aspects of human activity, including portfolio allocations, trading practices and dividend distributions (Girard and Hassan, 2008).

From a scientific standpoint, most research in the last decade on SRI focused on performance, seeking to understand whether this type of investment has financial costs beyond those associated with conventional investments. Several empirical studies have attempted to demonstrate a causal link between the effect of introducing non-financial criteria in the investment process and the financial performance of SRI funds or SRI indices. Recently, a meta-analysis proposed by Revelli and Viviani (2015) concluded that the consideration of corporate social responsibility in stock market portfolios is neither a weakness nor a strength compared with conventional investments and that the heterogeneous results in prior studies largely reflect the SRI dimensions under study. In this perspective, Barnett and Salomon (2006) demonstrate that SRI fund performance increases with intensified screening. Capelle-Blancard and Monjon (2014) note that greater strategy distinction is associated with better financial performance, as well as that positive screenings promoting best ESG practices are less harmful than negative screenings that exclude entire sectors. From another side, the resilience of the Islamic financial market to the subprime crisis triggered substantial research interest. Previous findings suggest that sector screening imposed by Islamic funds should not hinder performance (Wilson, 2001). Similarly, Hayat and Kraeussl (2011) report no statistically significant differences between the risk-adjusted performance of Islamic mutual equity funds or indexes and their conventional benchmarks. Hussein and Omran (2005) further suggest that Islamic indices may provide better returns than conventional indices in times of financial distress. For example, the exclusion of high-profile firms such as Enron and WorldCom, due to their excessive indebtedness, enabled the Dow Jones Islamic Market Index (DJIMI) to outperform its conventional counterparts after both firms collapsed in, respectively, 2001 and 2002. Significant international studies also confirm the better performance observed during the subprime crisis by Islamic developed market indices (Walkshaeusl and Lobe, 2012) and funds (Hoepner et al., 2011). Walkshaeusl and Lobe (2012) note that the performance difference is largely attributable to the exclusion of financial stocks from *shariah*-screened portfolios, but however, they predict that such superior performance should not persist over time. Merdad et al. (2010) accordingly highlight the underperformance of Islamic funds during buoyant periods. This insight suggests a means to investigate how the greater performance recorded by Islamic investments during times of financial distress might be sustained during stable periods.

Islamic finance and SRI share clear similarities in their objectives and claims (e.g., promoting social welfare through ethics). Williams and Zinkin (2010) highlight the compatibility of Islamic ethics and classic business ethics as fundamental sources of current SRI practices. However, this study also suggests that a strategy that focuses only on excluding "sinful" activities is insufficient to comply with all ethical and social guidelines prescribed by Islamic sources, such that the integration of ESG indicators in the Islamic investment process may be necessary. A survey among Islamic finance practitioners shows that 98.8% of respondents believe that promoting social responsibility in financial transactions would reconcile Islamic financial institutions with their ethical origin (Sairally, 2007), leading the author to conclude that Islamic investment could "learn from the more proactive engagement practices of SRI funds whereby they encourage companies to be more responsive to society's expectations" while still preserving their financial performance. Many justifications in previous works support mixing Islamic and SRI strategies. Forte and Miglietta (2007) show that Islamic investment and SRI have different characteristics in terms of asset allocations, econometric profiles and sector exposure. Despite empirical evidence that both Islamic and SRI funds are more oriented toward growth and small-cap stocks (Walkshaeusl and Lobe, 2012), in very developed SRI markets, SRI funds are more oriented toward large caps (Bauer et al., 2005). Therefore, from a financial point of view, integrating SRI filters into an Islamic portfolio, or vice versa, might provide complementary investment classes for both types of investors. It also could produce diversification benefits for fund managers, by reducing the non-systematic risk that stems from differences in Islamic and SRI portfolio profiles. Finally, incorporating positive ESG screening in Islamic investments might mitigate exposures to environmental and ecological risks that Islamic investments suffer, due to their traditional orientation toward industrial and fossil energy sectors (Forte and Miglietta, 2007).

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