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Comparative risk adjusted performance of Islamic, socially responsible and conventional funds: Evidence from United Kingdom

Krishna Reddy[a,*], Nawazish Mirza[b], Bushra Naqvi[c], Mingli Fu[d]

[a] Department of Finance, Waikato Management School, The University of Waikato, Private Bag 3105, Hamilton 3240, New Zealand
[b] SP Jain School of Global Management, Dubai Campus, United Arab Emirates
[c] Lahore University of Management Sciences, Lahore, Pakistan
[d] Waikato Management School, University of Waikato, Hamilton, New Zealand

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ABSTRACT

This study investigates the risk and return characteristics of Islamic funds in comparison with SRI and the conventional open-end mutual funds for the UK, which, having attracted over £11.7 billion in Islamic investment in the past decade has emerged as the largest financial market for Islamic funds in the west. In addition, contrasting with previous literature, this research categorizes SRI and Islamic funds into two distinct types in order to allow a fair comparison. Our findings demonstrate that Islamic and SRI funds in general perform close to the conventional funds with significantly better risk-return tradeoff in US focused funds. Results further indicate that the UK-based Islamic and SRI funds were less effected during financial crisis as the magnitude of loss was significantly lower for them when compared to conventional funds. The research suggests that Islamic and SRI funds do provide a rational substitute and investors can benefit from investing in these funds as ethic and faith-based screening criteria do not affect the returns of Islamic and SRI funds adversely. This was also substantiated by our findings on investment behavior of these funds.

1. Introduction

Ethical investment funds, such as socially responsible investing funds (SRI) and faith-based investment funds, like Islamic funds (also known as Shariah compliant funds) have experienced significant growth globally compared to conventional funds. The total volume of Islamic financial investment in the last two decades has grown 15%-20% a year, with Islamic financial assets exceeding US$1 trillion in recent years. SRI funds have also grown by 30% since 2005, with total volume of assets exceeding US$3 trillion (Bennett and Iqbal, 2013). If the dramatic growth in SRI funds is the result of an increased awareness and care for the environment and social problems, the growth in the Islamic funds might be the result of an increasing wealth of the world's growing Muslim population. This exponential growth over the years warrants the appraisal of these SRI and Islamic funds; and thus this paper empirically investigates into a potential reason for the growth of these two types of funds, that could be the difference in their performance vis-a-vis the conventional funds.

SRI funds emerged in 1970s due to investors' demand for screening out weapons and other "sinful" stocks. SRI funds link the investors' financial goals with their environmental, social, ethical and corporate governance concerns (Ghoul and Karam, 2007; Gil-Bazo et al., 2010). In 2001 in the US, a total of 219 mutual funds adapted social screens, which included non-equity funds, and various other funds followed. By 2010, managed assets, which followed SRI strategies, earned US $3.07 trillion (Lee et al., 2010). In Europe, the value of SRI assets accounts for €1.15 billion, taking up 10–15% of all managed assets. Institutional investors, such as charities, pension funds and religious groups, (e.g. Methodists, Quakers, Presbyterians and Anglicans), own around 94% of these assets (EUROSIF, 2006). A similar situation exists in the US, where the SRIs account for $2.29 billion which is about 9.4% of the total managed assets (Social Investment Forum, 2005). World-wide, the total value of SRI is approximately €7594 billion. Europe has the largest value at €4986 billion invested internationally, with the UK being a major player in these markets, followed by the US with a value of €3069 billion internationally (EUROSIF, 2010).

On the other hand, faith-based investing funds refer to investing in financial products that conform to and are consistent with investors' religious or moral beliefs (Ghoul and Karam, 2007) and Islamic funds are the most prominent in this category. Islamic funds must abide by Shariah principles, which are to be free of Riba (interest), Maysir (gambling and pure games of chance), and Gharar (selling something that is not owned or that cannot be described in accurate detail in terms of type, size, and amount) (El-Gamal, 2000) and illegal activities.

* Corresponding author.
E-mail addresses: krishna@waikato.ac.nz (K. Reddy), nawazish.mirza@spjain.org (N. Mirza), bushra.naqvi@lums.edu.pk (B. Naqvi).

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Table 1
Similarities and differences between Islamic and SRI funds.

Characteristics	Islamic Funds	SRI Funds
Exclude industries like tobacco, alcohol, armaments and pornography, etc.	Yes	Yes
Non financial criteria for screening	Yes	Yes
Filter according to Islamic values, eg. exclude interest based activities (Siddiqi, 2006) and other	Yes	No
Filter according to moral values, ethics, corporate social responsibility, environment, stakeholders	No	Yes
Binding decisions of Supervisory Committee (Abdelsalam et. al., 2014)	Yes	No
"Purification process"[a]	Yes	No

Note: Table 1 provides a concise summary of the attributes of Islamic and SRI funds, highlighting the main similarities and differences among them. Both types of funds face several restrictions in non-financial criteria and Islamic funds are bound by a financial purification process.

[a] Abdelsalam et. al. (2014) highlight the purification process as one where interest-based earnings are donated to charities.

Due to above mentioned constraints, Islamic funds are free of interest-based debt, speculation or margin trading. They also exclude conventional financial sectors and impose additional financial screening to ensure that the level of conventional debt does not exceed the Shariah tolerated threshold. Despite these restrictions the Islamic mutual funds have grown in size from approximately $200 billion in 2003 to an estimated $1.8 trillion at the end of 2013 (Bennett and Iqbal, 2013) and since Muslims represent 21% of the world's population and are growing at a rate of 1.84% annually, there is potential for these funds to grow further. According to Girard and Hassan (2008), Islamic funds have great potential to grow and the market annual growth rate currently is approximately 15% (Hassan et al., 2010).

It is interesting to note that due to the enormous growth of Islamic funds, even conventional funds have started offering similar customized financial products to cater to the growing needs of all investors. This could be due to the fact that regardless of the religious influence on the characteristics of these funds, they are equally desirable for both Muslim and non-Muslim investors. It is essential to make a fair comparison among Islamic, conventional and SRI funds on neutral grounds in order to make the benefits of one product over the other accessible to the larger spectrum of investors, including Muslims and non-Muslims.

Islamic funds were earlier seen as a subset of the SRI funds, and prior research relating to the evaluation of funds have treated these funds in the similar manner as well (Elfakhani and Hassan, 2005). This research explicitly regards SRI and Islamic funds as distinct types of mutual funds, and draws a comparison between them. Such an exercise has been missing from research with Abdelsalam et al. (2014) pointing out that no other research had been carried out in that domain before their study; and the focus had been repeatedly drawn away from Islamic funds and centred on SRI funds as the superset of funds incorporating both types. Table 1 is apposite in such a situation as it serves to highlight the key similarities as well as differences in the characteristics of these two types of funds, furthering the need for the distinction made in this study.

Since Islamic and SRI funds limit choices for diversification based on their ethical or faith-based screening, it is not clear whether they can reduce risk with a smaller set of investible assets, and if it comes at the cost of low returns. According to the modern portfolio theory, diversification helps reduce risk for investors, and the risk return trade-off suggests an inherent bargain between risk and return of different investments. Therefore, this study not only investigates the differences in the performance of SRI and Islamic funds but also explores if such funds (Islamic and SRI) provide some latitude to the investors facing risk-return tradeoff vis-a-vis the dominant conventional funds.

Moreover, besides some initial research that reported relatively better performance of Islamic indices compared to their conventional counterparts (Hussein, 2004; Hakim and Rashidian, 2004); recent studies by Abderrezak, (2008), Mansor and Bhatti, (2011), Hoepner, Rammal, and Rezec (2011) in contrast, witnessed the underperformance of Islamic mutual funds compared to the conventional funds. In addition, there are some studies presenting the view that either there is no statistically significant difference between conventional and Islamic mutual funds (Merdad et al., 2010) or that the results are mixed and circumstantial in nature. Thus, this study represents one of the latest attempt to resolve the conflicting results by providing empirical evidence for Islamic and conventional mutual funds from a market where investors' mutual fund choice could well be independent of religious disposition. In addition, this study makes contribution to the limited strand of literature that compares Islamic and SRI funds as two distinct fund types.

In addition to the baseline comparison between the different fund types, this study further divides the total sample period into different subsamples for varying market conditions, and examines the funds' performance in each subsample. Need for this subsampling stems from the fact that financial markets often experience the effect of bullish and bearish situations (Abdullah et al., 2007), and the perceived resilience of Islamic funds during such events raises the need for an examination of their risk and return behavior during different time periods, including financial crises. This assessment is further warranted by the recent trends accentuating Islamic finance at every academic research and policy debate. The increasing frequency of debates, academic and policy conferences; are among the factors creating an impression that Islamic modes of investing are not only different but are desirable and somewhat better in terms of the risk-return trade-off compared to their conventional counterparts.

Several studies have previously investigated the performance of mutual funds in North America and Europe and during different market conditions (especially global financial crisis), but there are no studies that compare the characteristics and performance of SRI, Islamic and conventional funds based in the UK.[1] This is surprising as the UK market is the largest financial market for Islamic funds in the west, with London having acquired over £11.7 billion in this type of investment over the past decade.[2] The London Central Portfolio regards Islamic investment as a key factor in its financial market, where more financial products are offered than any other country in the west. Considering the UK for this study provides a rare opportunity to evaluate the risk and returns on Islamic funds vis-à-vis conventional funds, in a financial market where investors' decision making is independent of religious influence. Previous literature largely concentrated on Islamic funds in Islamic countries such as Malaysia and Saudi Arabia, making for a noticeable gap in research regarding such funds based in developed countries with no religious influence on market trends. With authorities coming together to increase investor and issuer knowledge regarding Islamic funds in the UK, it is important to consider the viability of this instrument in the western financial markets for investors in the years to come.

This study examines the relative performance of Islamic, SRI, and

[1] To the best of our knowledge.

[2] According to "Islamic investment becoming 'financial powerhouse' in the UK" Source: http://blueandgreentomorrow.com/2014/03/24/islamic-investment-becoming-financial-powerhouse-in-the-uk/