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Sharīʿa Guidelines

A Look at the Differences and Their Impact on Performance

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ABSTRACT

This paper aims to take a closer look at the main differences in *sharīʿa* guidelines currently in effect, and to gauge the impact these can have on performance. In order to simplify the process, and due to the lack of transparency still prevalent in this segment of the investment industry, the scope of the investigation is limited to the two sets of guidelines applied by the major global Islamic indices: the FTSE Global Islamic Index and the Dow Jones Islamic Market Index. Also pointed out are the differences, in terms of regional and sector allocations, that the *sharīʿa* guidelines create vs. traditional global indices, and the impact that the *sharīʿa* guidelines have had on the returns achieved since 1998. Finally, this paper identifies the companies whose exclusion from the universe of Islamic investments is having the largest impact.

I. INTRODUCTION

When it comes to comparing the performances of Islamic equity funds, every fund manager is quick to point out that in order for the comparison to be valid, it is first necessary to determine whether the *sharīʿa* guidelines of the funds under review are similar. This is the reason that it is quite useful to look at what the current *sharīʿa* guidelines are and then to ascertain their impact on the regional and sector allocations of Islamic funds as well as on the two all-important factors: performance and risk.

II. CURRENT *SHARĪʿA* GUIDELINES

The *sharīʿa* guidelines currently being applied by the largest Islamic fund managers are examined first. Given the fact that, apart from a few notable exceptions, information about Islamic funds is difficult to obtain, the parameters listed on the Web site of Dow Jones Indexes, at http://indexes.dowjones.com/djimi/imparameters.html, are used in place of more direct sources of information. Under *sharīʿa* guidelines, the following business sectors are excluded from the universe of permitted investment: alcohol, tobacco, pork-related products, financial services, arms manufacturing, gaming, and pornography.

Although very little differences exist between various *sharīʿa* boards regarding prohibited sectors, the same cannot be said when it comes to the financial ratios that must be applied for screening potential as well as existing investments. Not only do *sharīʿa* boards differ on the types of screens that need to be applied, they also disagree on the definition as well as on the level of the ratios falling into the same category. The only type of ratio being applied by every *sharīʿa* board is the one concerning the leverage of a company. The standard definition and level for this ratio, the specifications that are gaining ground in the industry and that have been chosen by both the Dow Jones Islamic Market Index and the FTSE Global Islamic Index, is that total debts divided by total assets must be lower than one-third. However, the following leverage ratios are also used: total debts divided by equity must be lower than 30% or 33%; and loans plus cash divided by total assets must be lower than 50%.

The second most common type of financial screen deals with the level of interest income received by any given company. Three different definitions and levels are being used:

1. Non-operating interest income divided by operating income must be lower than 9%.
2. Interest income divided by total revenue must be lower than or equal to 15%.
3. The three-year average of interest income divided by total income must be lower than or equal to 10%.

Finally, a third financial screen that sometimes is required concerns short-term liquidity. It is also defined in three ways:

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1. Accounts receivable divided by assets must be lower than 47%.
2. Accounts receivable divided by assets must be lower than or equal to 50%.
3. Accounts receivable divided by market value must be lower than or equal to 50%.

III. Performance Impacts

This paper initially intended to compare the impact that the different *sharīʿa* guidelines applied by the Dow Jones Islamic Market Index and the FTSE Global Islamic Index are having on regional and sector allocations as well as on performance. Unfortunately, inasmuch as the constituents of the former index result from the screening of the traditional Dow Jones index as well as from a selection within their Islamic investment universe, it is not possible to determine the source of the differences. The divergences in allocations and performance could be a result of screens or of stock selection; it is impossible to tell which.

Nonetheless, it is interesting to list the following differences. The table below spells out the regional allocations (comprising the regional blocks of the Americas, Europe and Africa, and Asia/Pacific) and sector allocations (distributed among energy, utilities, transportation, consumer goods and services, healthcare, capital goods, basic industries, industrials, and miscellaneous) for the Dow Jones Islamic Market Index and the FTSE Global Islamic Index as of March 15, 2000. The last sector, industrials, accounts for 11% in the Dow Jones Islamic Market Index but has no counterpart in the sector breakdown of the FTSE Global Islamic Index; likewise, transportation is a component of the FTSE Global Islamic Index but not separately present in the Dow Jones Islamic Market Index.

Table 1. Regional and Sector Allocations: DJIM and FTSE Global Islamic Indexes

	Dow Jones Islamic Market Index	FTSE Global Islamic Index
Regional Allocation		
Americas	69%	62%
Europe and Africa	18%	26%
Asia/Pacific	13%	12%
Sector Allocation		
Energy	9.56%	9.01%
Utilities	13.43%	7.16%
Transportation	n/a	1.13%
Consumer goods and services	14.00%	28.34%
Healthcare	13.63%	15.06%
Capital goods	34.09%	33.42%
Basic industries	4.23%	4.11%
Industrials	11.01%	n/a
Miscellaneous	0.05%	1.76%

It is also useful to compare the performances of the two indices over the past three years. Their performance in 1998 is theoretical because both indices were launched at the start of 1999. In all three years, despite the differences of the indices in regional and sector allocations, their returns are quite similar, with the exception of 1999, but even then, the difference in returns was only 323 basis points.

TABLE 2. RELATIVE PERFORMANCE: DJIM AND FTSE GLOBAL ISLAMIC INDEXES

Year	Dow Jones Islamic Market Index	FTSE Global Islamic Index	DJIM – FTSE Difference (basis points)
1998	25.91%	25.57%	34
1999	29.22%	32.45%	–323
2000	–18.60%	–18.37%	–23

IV. THE *SHARĪᶜA* VS. TRADITIONAL INDEXES

Fortunately for the purposes of this paper, one is able to determine the impact of *sharīᶜa* guidelines on the returns achieved vis-à-vis a traditional index. Given the fact that no judgment is involved in the screening and re-balancing process of the FTSE Global Islamic Index, we need only compare the regional and sector allocations, the risks, and the returns between that index and the FTSE World Index in order to have an idea of the changes caused by the implementation of the index's *sharīᶜa* guidelines. These guidelines screen only for leverage, by requiring that total debts divided by total assets be lower than one third. As shown in the table below, the FTSE Global Islamic Index and the FTSE World Index contain a number of differences with respect to regional and sector allocation.

TABLE 3. REGIONAL AND SECTOR ALLOCATIONS: FTSE GLOBAL ISLAMIC AND WORLD INDEXES

	FTSE Global Islamic Index	FTSE World Index
Regional Allocation		
Americas	62%	57%
Europe and Africa	26%	29%
Asia/Pacific	12%	14%
Sector Allocation		
Financials	0%	19.63%
Energy	9.01%	5.58%
Utilities	7.16%	11.22%
Transportation	1.13%	1.17%
Consumer goods and services	28.34%	22.72%
Healthcare	15.06%	9.88%
Capital goods	33.42%	24.26%
Basic industries	4.11%	3.75%
Miscellaneous	1.76%	1.78%

TABLE 4. RELATIVE PERFORMANCE: FTSE GLOBAL ISLAMIC AND WORLD INDEXES

Year	FTSE Global Islamic Index	FTSE World Index	Islamic – World Difference (basis points)
1998	25.57%	20.94%	463
1999	32.45%	24.17%	828
2000	–18.37%	–12.23%	–614

The returns achieved by these indices over the last three years are displayed in the following table. It has thus been demonstrated that Islamic investors can earn better returns than traditional investors and that the differences can be substantial, as in 1999 the Islamic index outperformed the traditional index by 828 basis points. However, as exemplified by the year 2000, the Islamic index is by no means guaranteed to outperform, and there will be years in which traditional indices will do better than Islamic ones. It is also to be noted that the FTSE Global Islamic Index is riskier than the FTSE World Index. The standard deviation of the Islamic index is 15.6%, while that of the traditional index is 14.9%. There is a tracking error of 3.5% for the Islamic index vs. the traditional index. This higher risk is mainly explained by differences in sector exposure, differences that stem directly from the *sharīʿa* guidelines applied to the Islamic index.

On the company level, six firms have a weighting greater than 0.5% in the FTSE World Index but are excluded from the FTSE Global Islamic Index: General Electric (weight 2.3%), Vodafone (1.03%), Citigroup (1%), IBM (0.88%), AIG (0.82%), and HSBC (0.53%). The FTSE Global Islamic Index in turn has 15 concerns with a weight of more than 0.5% compared to the FTSE World Index. They are: Cisco Systems (+ 1.54%), Intel (+1.43%), Microsoft (+1.29%), Exxon Mobil (+ 0.96%), Pfizer (+ 0.91%), Oracle (+ 0.78%), Wal-Mart (+ 0.78%), Nortel (+ 0.76%), BP (+ 0.69%), Sun Microsystems (+0.66%), EMC (+ 0.66%), Nokia (+ 0.64%), Merck (+ 0.56%), Toyota (+ 0.56%), and Coca-Cola (+ 0.52%).

V. CONCLUSION

In light of this information, one can draw a number of conclusions. First, Islamic investors can obtain good absolute returns while complying with their religious beliefs. They can also achieve superior relative returns. However, they are taking greater risks than traditional investors. Being an Islamic investor implies three investment biases. On regional allocation, Islamic investors have higher exposure than traditional investors to the United States. On sector allocation, they have greater exposure to the technology and pharmaceutical industries. Finally, FTSE Global Islamic Index differs from the FTSE World Index with respect to individual companies' weightings within the index.