ISBN: 978-623-92201-0-5

DO IEF'S MANAGERS KEEP THEIR PROMISES? : THE CASE OF MALAYSIAN ISLAMIC EQUITY FUNDS

Feranda Ayu Syafitri* and Yunieta Any Nainggolan
School of Business and Management, Institut Teknologi Bandung, Indonesia
*Email: feranda.ayu@sbm-itb.ac.id

Abstract. Islamic Finance in Malaysia has been growing significantly for the past decades. Many finance products in Malaysia today, one of them being the equity funds have adopted and inserted the Islamic law or best referred as shari'ah law in their business exercise. However, the information of how comply the funds to shari'ah law is often absence in the prospectus. Thus, this reason motivates us to examine the fund's shari'ah compliance based on their own screening method and MSCI Islamic Index. The result on this study shows that IEFs are more complied to their own screening index stated on their prospectus with average of compliance rate 57.94% rather than MSCI Islamic Index (53.78%) with debt ratio screening being the strictest screening criteria to pass. Malaysian IEFs with more non-Malaysian firms in their holdings also appear to be more complied than those with more Malaysian firms.

Keywords: Islamic Equity Funds; Malaysia; Shari'ah Screening Method; Shari'ah Compliance

INTRODUCTION

The ethical investment or broadly known as Socially Responsible Investment (SRI) (Renneboog, et al., 2008) has grown substantially for the last two decades (Miglietta and Forte, 2011). One of the important classes of ethical investment or SRI is known as Islamic Equity Fund (IEF). The moral standards that regulate IEF are the gathering of conventional religious lessons of Islam and the concept of *halal* and *haram*. *Halal* in Arabic is defined as permissible or lawful, while the opposite of it, *haram*, means unlawful or forbidden. What include in *halal* and *haram* are explained mostly from the Qur'an and *Sunnah*, which is the practice of the Prophet. Nowadays, investments which are *shari'ah*-compliant are one of the fastest growing financial sectors globally (Al-Salem, 2009), WITH Malaysia being the country with one of the most Islamic Finance Product.

As mostly the objective of financial investments is to maximize the investor's wealth, in IEF it becomes the second objective after the *shari'ah* compliance. This is supported by a survey conducted by finance professional on the most necessary factors in assessing the performance of Islamic Financial Institutions which shows that majority of respondents agreed upon the compliance with *shari'ah* regulations is more important than maximization of shareholder's wealth (Obaidullah, 2005). Thus, it is essential for the managers of IEF to ensure that their fund is strictly comply with the *shari'ah* law with a help from Shari'ah Advisory Board (SAB).

Meanwhile, the information regarding the *shari'ah* compliance is often absence in the prospectus and annual report. Thus, this research is made in aim to provide evidence on the compliance of IEF specifically those domiciled in Malaysia with the *shari'ah* law based on the screening compliance as promised in respective fund's very own prospectus and to compare them with Morgan Stanley Capital International (MSCI) Islamic Index. The subject of this study is Global and Malaysian investors who seeks for an ethical investment under the umbrella of *shari'ah* law. The data will include around 40 IEFs in Malaysia with 712 firms' financial data and ratio. Moreover, the data of IEFs holding is only limited for one year which is on 2017.

LITERATURE REVIEW

IEFs speak to the usage of *shari'ah* standards in capital market exchanges dependent on the idea of halal (permissible) and haram (impermissible). In other words, Islamic Funds should have all aspect categorized as Halal and should not have those categorized as haram. However, in the current time, we can find that some allows the fund to include those prohibited or haram activities, because to quotes Khatkay and Nisar 2007, "fully *shari'ah* compliant activities are extremely rare". Previous studies done by Nainggolan et al., 2011 which focused on examining the compliance of IEFs based on the MSCI Islamic Index also found that compliance of IEFs' holdings globally to the financial ratio screening are relatively low (28%), while for business activity screening are high (95%). Because each IEFs might adopt different screening methodology from different institutions or even has their own which previously has been adjusted to the fund's objective and situation, we consider that IEF's will more likely to pass its own or preferred screening criteria stated on their prospectus:

H1: IEFs are more likely to comply with the screenings stated on their prospectus.

ISBN: 978-623-92201-0-5

With a supervision from most highly respected and prominent scholars, The MSCI index has been well-known of its rigorous *shari'ah* screening methodologies (Nainggolan, 2011). Supported by the fact that most of Malaysian IEFs adopted the screening criteria of SAC Malaysia which is considered as less stringent than the Dow Jones and MSCI (Engkuchik, 2016), we consider that funds who passes the MSCI Islamic index have a more rigorous and conventional screening method, thus will have a bigger fraction for compliance based on its own screening method stated on its prospectus. This leads to:

H2a: IEFs that passes the MSCI index are more likely will pass its own shari'ah screening criteria

Derigs and Marzban (2008) stated on their research that firms can be considered as a *shari'ah* compliance based on one screening methodology and screened as non *shari'ah* compliance according to another screening methodology. This is also supported by the FTSE factsheet that said using the volatile measure such as trailing 12-month market cap can cause the company not passing the screening index because of the market volatility. Thus:

H2b: IEFs that passes the MSCI index are less likely will pass its own shari'ah screening criteria

Each IEF might have a different number of members in their SAB which might affect the degree of *Shari'ah* compliance. According to the Yermack (1996) a smaller size of SAB will improve the performance of IEFs because it ensures a more effective communication and coordination. An addition to the SAB matter, there is also a condition of cross membership which definition is when one member of the SAB has position in several agencies which allows the SAB member to have more experience (Muda, 2017). The SAB members may also have prestige, broad links, and visibility which can intensify their opinion on *Shari'ah* matter. Thus:

H3: IEFs with more competent SAB has a higher Shari'ah degree of compliance

H4: IEFs with smaller SAB size tend to be more Shari'ah-compliant

H5: IEFs with more cross-board members tend to have a higher Shari'ah degree of compliance.

METHODOLOGY

Measuring IEFs' Shari'ah Compliance

We measure the *shari'ah* compliance based on the firm's holdings data. The first *shari'ah* compliance will be measured based on fund's business activities. Businesses that are directly involved in non-halal products should generate revenue less than the respected threshold which vary from 5 percent to 20 percent. IEF's holding that complied to this will be given a score of 1 while those who do not pass will be given a score of 0. Any holdings which business involved in the non-*shari'ah* business activities as if told in its own prospectus and generate revenue more than the given benchmark will be considered as non *shari'ah*.

Second screening compliance is accounting screen which will be based on the financial ratio. Firms that has an exaggerated amount of leverage or excessive proportion of liquid assets are forbidden by the *shari'ah* law principal.

For each fund, we total up the scores across the fund holdings and convert it to the percentage value to see how comply the firms are based on the financial ratio. *Furthermore, author will also measure the shari'ah compliance among IEF's holdings to see which shari'ah criteria is the hardest to pass and which one is the easiest to pass.*

Comparing IEFs' Shari'ah Compliance

To answer the second hypothesis, this research will use Paired Sample T-test methodology. Paired Sample T-test is used to determine whether mean difference between two groups is equal to 0. The 2 groups here are the IEF's screening compliance percentage based on their own prospectus and the *Shari'ah* compliance based on the MSCI Islamic index. The null hypothesis of this method would be that the true mean difference (μd) is equal to 0:

$$H_0;\ \mu d = 0$$
$$H_1;\ \mu d \neq 0$$

If there is mean difference between these two groups, we will see which group has the higher compliance. This will help us to proof *H2a* and *H2b.*

Determining factors that influence IEFs' shari'ah compliance

After finding out the compliance of IEFs, this research further examine some factors that potentially has a linear relation to the compliance of IEFs. To see which factors, author uses OLS regression. OLS regression is used to gauge the connection between at least one independent factor and a dependent. There will be 3 model used in this research. Each of the three models is differentiated based on the independent variable of SAB characteristics which are the SAB size, SAB competence and SAB cross-board member due to the possibility of correlation among this character.

ISBN: 978-623-92201-0-5

SAB Size Model

$$Compliance_i = \alpha_1 Holdings + \alpha_2 \ln(Size_i) + \alpha_3 \ln(Size_i)^2 + \alpha_4 \ln(Age_i) + \alpha_5 Fee_i + \alpha_6 SABsize + \varepsilon_i \quad (1)$$

SAB Competence Model

$$Compliance_i = \alpha_1 Holdings + \alpha_2 \ln(Size_i) + \alpha_3 \ln(Size_i)^2 + \alpha_4 \ln(Age_i) + \alpha_5 Fee_i + \alpha_6 SABcompetence + \varepsilon_i \quad (2)$$

SAB Cross-board Member Model

$$Compliance_i = \alpha_1 Holdings + \alpha_2 \ln(Size_i) + \alpha_3 \ln(Size_i)^2 + \alpha_4 \ln(Age_i) + \alpha_5 Fee_i + \alpha_6 SABcrossboard + \varepsilon_i \quad (3)$$

where Holdings is the percentage of non-domestic firms IEFs invested in or firm outside of Malaysia; Size is fund size, measured as total assets under management (in MYR million); Age is fund age, measured in months from the inception date to the test date; and Fee is the management fees charged by the fund. SAB size is the number of members sits in fund's SAB, SABcompetence is the average value of "9 fits and proper" criteria across SAB members, and SABcrossboard is the number of SAB cross-board members.

FINDINGS AND ARGUMENT

This research final data consists of 712 firms in total that is collectively held by 40 IEFs domiciled in Malaysia. Although that Malaysia here has the biggest number of firms, some funds which are being observed in this research also have bigger percentage of holdings that are domiciled outside of the Malaysia. For example, AM-Namaa' Asia-Pacific Equity Growth which has only 9.09% of Malaysian holdings in their investment. Thus, this research will also examine whether the percentage of Malaysian holdings in the funds affect the fund's compliance degree.

The summary statistics of IEF's overall compliance based on the three different screening methodology which are: IEFs' very own screening criteria (based on the prospectus), MSCI screening criteria, and SAC of SC screening criteria is shown in Table 1. IEFs are most complied if screened by their own screening criteria as shown in the Table 1. In average IEFs total compliance by their own screening criteria is 57.94% while the lowest would be the compliance by the MSCI Islamic index (53.78%). This is consistent with *H1* that IEFs are more likely to comply with their own screening criteria. This may due to the condition that most countries- *including Malaysia*- are exposed to conventional finance, thus are subject to riba' (Adam et al., 2012).

Table 1 Summary Statistics of IEFs' Overall Compliance based on Holdings

	Prospectus Screening Criteria	MSCI Screening criteria	SAC of SC Screening Criteria
Mean	57.94%	53.78%	56.30%
Median	57.50%	53.00%	55.00%
Maximum	92.00%	89.00%	89.00%
Minimum	34.00%	18.00%	28.00%
Statdev	13.28%	15.45%	15.05%
NObs	40	40	40

Our research shows that debt ratio with 24-months trailing market capitalization as the denominator is the strictest financial criteria to pass with total percentage of holdings passes the screening is 60.54% and followed by debt ratio with total assets (63.36%). This may due to the exposure of conventional finance in which in order to leverage profitability, firms are better finance their company with debt (Khatkay and Nisar,2007). Financial criteria that becomes the easiest to pass by firms is the cash ratio over total assets with 94.54% of firms passes this screening criteria shows that it is easy for SAB to ensure firms have an adequate amount of cash to avoid riba' from the interest income.

From OLS regression, the three models' R square from prospectus compliance are 31% which shows the representation of the independent variable to the prospectus compliance (dependent variable). Surprisingly, the result of the OLS pointed out that there is no significant linear relationship between the independent variable (Fund age, Fund size, Management fee, percentage of Malaysian holdings, SAB size, SAB competence, and SAB cross-board membership) to the degree of IEFs' compliance based on the prospectus. Thus H3, H4, and H5 are being rejected. This may happen perhaps because a bigger size of SAB might provide a broader knowledge of their member thus it also contributes to the IEFs degree of compliance. It is however surprising to see that there is no significant linear relation happens to the SAB competence and SAB cross-board member to the *Shari'ah* compliance of IEFs. A further research on why this happen has been carried out, however there is not such a sufficient data found to support this finding. Perhaps it is also because similar research on the IEFs' compliant based on their very own screening criteria has not been plenty to date and the time constraints that limit the further research on this.

Meanwhile, the result of OLS regression from MSCI compliance model have R-square of 0.40, 0.41 and 0.40 for SAB Size model, SAB Competence model, and SAB cross-board model respectively which shows a higher percentage of representation of the independent variable to the MSCI Islamic Index compliance (dependent variable) compared to the OLS models for the Prospectus Compliance.

Results from the SAB Size's Model and SAB Cross-member's Model show that IEFs with less Malaysian holdings tend to be more *Shari'ah* compliant. Giving that the coefficient is small (-0.002) for both SAB size's model and SAB's cross-board member's Model shows that compliance degree on IEFs does not depend on the Muslim status of where the firms are domiciled in. This model thus shows that for every 1 percentage lower of IEFs' Malaysian holdings, the *Shari'ah* compliance degree will increase for 0.2%. This happens to only MSCI compliance and not to the prospectus compliance probably because of the universal and an international status of MSCI index. The fact some of IEFs being observed also invest their fund in non-Malaysia firms might allow firms outside of Malaysia getting more exposure on the MSCI Islamic index thus contribute more to the degree of compliance.

Table 2 presents the result on Paired T-test analysis and shows that there is significant difference in means between the percentage of prospectus compliance and MSCI Islamic index compliance. This further confirms that IEFs that pass the MSCI Islamic Index are more likely to pass their own screening criteria as the percentage of compliance based on the prospectus screening criteria is higher that the MSCI (by 0.042), thus consistent to our *Hypothesis 2a* that IEFs that comply to the MSCI Islamic Index are likely to comply with their own *Shari'ah* screening criteria. This result thus shows that MSCI Islamic index tend to be more rigorous when compared to the screening criteria constructed by the IEFs boards. Additionally, this may also due to the different investment objective by each IEF that affect the *Shari'ah* screening criteria making it easier for SAB to ensure the *Shari'ah* compliance of the respective IEFs.

Table 2 Paired T-test Result

	Paired t-test result		
	Mean	P-Value	Nobs
prospectuscompliance-MSCIcompliance	0.042	0.000	40

CONCLUSIONS

Result shows that IEFs are more complied to their own screening index compared to the universal screening index such as the MSCI Islamic index and the SAC of SC Islamic index. However, the IEFs compliance rate of those three indexes: prospectus index (57.94%); MSCI Islamic Index (53.78%); and SAC of SC (56.30%) Islamic index shows that it is very hard to find a fully *Shari'ah* compliant IEFs.

From the OLS analysis, this research found out that there is no significant linear relation between the SAB characteristics (SAB size, SAB competence, and SAB cross-board membership) to the *Shari'ah* compliance degree of IEFs both based on their own screening index as well as the MSCI Islamic index. While other findings show that IEFs which has less Malaysian firms on their investment tend to be more *Shari'ah* compliant based on the MSCI Islamic index.

The Paired T-test sample analysis shows that there is difference in means between the compliance of IEFs own screening index and MSCI Islamic index which further show that IEFs that passes the MSCI index are more likely will pass its own *Shari'ah* screening criteria.

The result implication is that investors should be mindful when it comes to seeking for *Shari'ah* investments because there would always exist the compliance risk. According to the result of this study, managers of Malaysian IEFs are suggested to consider investing in firms outside of Malaysia due to the higher compliance rate.

ISBN: 978-623-92201-0-5

In addition, it is highly recommended to start the standardization of Shari'ah screening methodology to be constructed by relevant authority which applicable universally, and this is also in line with the statement of Nainggolan et al. (2011) and Zainudin et al. (2014. Variety of IEFs' background and circumstances might seem to make it very hard to be implemented, nevertheless it is not impossible (Zainudin et al., 2011).

As this research only limited for the Malaysian holdings, future research could also add the diversity of IEFs' domicile to see whether there is any significant difference among countries especially between Muslims and non-Muslim as this research seems to be very sensitive to that matter. Another thing that could be added is the SAB characteristics. Furthermore, the time series addition may also upgrade the research.

REFERENCES

Adam, N. and Bakar, N. (2014). Shariah Screening Process in Malaysia. *Procedia - Social and Behavioral Sciences*, 121, pp.113-123.

Al-Salem, F. (2009). Islamic financial product innovation. *International Journal of Islamic and Middle Eastern Finance and Management*, 2(3), pp.187-200.

Derigs, U. and Marzban, S. (2009). New strategies and a new paradigm for Shariah-compliant portfolio optimization. *Journal of Banking & Finance*, 33(6), pp.1166-1176.

Engkuchik, E. (2016). A Review of Securities Commission of Malaysia's Revised Shariah Stock-Screening Criteria. *Journal of Islamic Banking and Finance*, 4(1).

Ifsb.org. (n.d.). *IFSB*. [online] Available at: https://www.ifsb.org/ [Accessed 30 Apr. 2019].

Khatkay, M.H, Nisar, S. (2007). Shari'ah Compliant Equity Investments: An Assessment of Current Screening Norms. *Islamic Economic Studies.* [online] 15(1). Available at: http://www.irti.org/English/Research/Documents/IES/085.pdf [Accessed 12 March. 2019].

Mifc.com. (2017). [online] Available at: http://www.mifc.com/index.php?ch=28&pg=72&ac=54&bb=uploadpdf [Accessed 30 Apr. 2019].

Miglietta, F. and Forte, G. (2011). A Comparison of Socially Responsible and Islamic Equity Investments. *SSRN Electronic Journal*. [online] Available at: https://www.researchgate.net/publication/296471079_The_Theoretical_Impact_Of_The_Listing_Of_Syariah-Approved_Stocks_On_Stock_Price_And_Trading_Volume

Nainggolan, Y., How, J. and Verhoeven, P. (2011). Do Fund Managers Keep Their Promises?: The Case of *Shari'ah* Equity Funds. *SSRN Electronic Journal*.

Obaidullah, M. (2005). Rating of Islamic Financial Institutions: Some Methodological Suggestions. *Scientific Publishing Centre King Abdulaziz University*, (1426).

Renneboog, L., ter Horst, J. and Zhang, C. (2008). The Price of Ethics and Stakeholder Governance: The Performance of Socially Responsible Mutual Funds. *SSRN Electronic Journal*.

Zainudin, N. B., Miskam, S. B., & Sulaiman, M. B. (2014). REVISED SHARIAH SCREENING METHODOLOGY FOR SHARIAH-COMPLIANT SECURITIES: NEW STANDARD TO MEET GLOBAL EXPECTATION. research gate, 76-85.