CHAPTER ONE

INTRODUCTION

The theoretical issues on Islamic finance and banking have been an important issue among scholars in the Muslim world in the 1980s and the 1990s. Therefore, the discussions were concentrated mainly on the legality of capital market trading, speculation and interest free trading and banking (Al-Sharif (1990), El-Ashkar (1995), Eldin (1985), Elgari (1993), Metwally (1984), Rosly (1994) and Eid (1995)). The main conclusion concerning stock market trading is that it is lawful (i.e. Halal). Only recently, researchers and practitioners started to focus their studies on the empirical part of studying Islamic banking and finance.

With the tremendous growth in the academic interest on Islamic finance over the recent years, research on the performance of screened investment portfolio and non-screened investment portfolio has become popular among economists. Most of the studies investigate whether the returns and risk of screened investment portfolios are significantly different from those of non-screened investment portfolio.

Many finance and economic pundits as well as some prominent figures in the Islamic finance field have indicated, "Global crisis has little impact on Islamic finance[1]." Others, such as Ali Khan from University of Washburn[2], see in the current crisis an opportunity to prove that the Islamic finance is a better option to the current financial system.

[1] Tan Sri Dr. Zeti Akhtar Aziz, Bank Negara Malaysia Governor. Malaysian reserve.
[2] Asharaq Al-awsat newspaper.

Following the work of previous studies, this dissertation examines the return and risk of screened investment portfolio, which is represented by Kuala Lumpur Syariah Index[3] (KLSI) and non-screened investment portfolio, which is represented by Kuala Lumpur Composite Index[4] (KLCI), their long and short run relationships individually, with macroeconomic variables and firm specific variables in Bursa Malaysia. KLSI was first launched on April 1999 while KLCI in 1986. KLCI refers to the average price of 100 largest public-listed companies in Bursa Malaysia. On the other hand, KLSI keeps track the performance of all the Syariah compliant stocks listed on Bursa Malaysia. This Islamic index provides a benchmark for the islamically compliant stock performance fulfilling the demand of local and foreign investors who seek to invest in stocks that are compliant with the Islamic laws.[5] Subsequently, KLSI represents screened investment portfolio in our study.

1.1 Background of Islamic Finance

Siddiqi (2006) indicated that Islamic finance and banking has been in existence for the last 30 years. However, in terms of the theory Islamic banking and finance is still not very well developed. The basic argument here is that Islamic banking and finance is using the same conventional finance theory with little modifications. These modifications stem from the Shariah requirements but not from the objective of Islamic law. Siddiqi (2006) indicated that the earliest writing on the literature of Islamic banking and finance was in the forties of the twentieth century, while the earliest practice was in the sixties. The theory focused mainly on the prohibition of Riba or interest as it is known in most of the literature of

[3] On 22 January 2007 Bursa Malaysia Berhad (Bursa Malaysia), in collaboration with FTSE Group (FTSE) the global index provider, launched the FTSE Bursa Malaysia EMAS Shariah Index (FBM EMAS Shariah). http://www.klse.com.my/website/bm/market_information/FBM_emas_shariah.html

[4] On 6 July 2009 KLCI was renamed as FTSE Bursa Malaysia KLCI, http://www.klse.com.my/website/bm/media_centre/media_releases.html?/bm/media_centre/media_releases/subjects/ciupdate/20090624_091855188.html

Islamic banking and finance. In terms of practice, few interest free banks started in the sixties in Pakistan, Malaysia, and Egypt. At the end of the seventies, there were half a dozen banks in Egypt, Jordan, Kuwait, and the Gulf countries. In the following decades the Islamic banking and finance has flourished year by year moving from the banking sector to investment portfolio companies, mutual funds, and insurance.

"Globally, there were 300 Islamic financial institutions in more than 70 countries with total assets at the start of 2007 put at a staggering $300,000 million. Figures for the first half of 2007 show that the balance sheets of the top 20 banks in the GCC grew by more than 30 per cent over the corresponding period in 2006. The positive trends are expected to continue for the foreseeable future,"[6] This show how big this industry is and that it is potential is growing fast all over the world.

The Islamic Capital Market refers to a market where the capital market transactions, operations, and activities are carried out in ways that do not contravene Shariah principles and requirements. The Islamic finance in Malaysia started with the establishment of Pilgrims Fund Corporation 1963. However, it was not until 1983 that the First Islamic bank in Malaysia was established. There were two main Islamic banks namely bank Islam Malaysia and bank Muamalat. In 1993, Islamic based money market was launched. The security commission in its effort to meeting the objective of establishing Malaysia as an international Islamic capital hub the security commission established a department under the Market Policy and Development Division called the Islamic Capital Market Department (ICMD). Its responsibilities include conducting research and developing Islamic capital market products in the equity, debt, and derivative sectors, as well as analyzing the

[6] http://islamicfinancenews.wordpress.com/2008/01/31/islamic-finance-to-grow-to-3b-by-2012/

securities of listed companies. The work of this department is then presented to the Syariah supervisory council, which was established in 1996. The SAC adopted two approaches in introducing the Islamic capital market instruments. First is to study the validity of conventional instruments used by the local capital market from the Shariah perspective. The study focused on the structure, mechanism, and use of the instruments to ascertain whether they were against Shariah principles. Second is to formulate and develop new financial instruments based on Shariah laws. The SAC is also responsible for issuing a list of Shariah-compliant securities list, which is updated twice a year.

The first was Rashid Hussien Bhd. Islamic index (RHB Islamic index) which was launched in 1996[7]. However, the main public Islamic index was launch in 1999[8]. The reason behind mentioning this section is to show the investors' sentiment towards Syariah compliant stocks, which would be preferred in its avoidance of the non-islamically compliant stocks. Islamic market must serve the five objectives of *Shariah*, the protection of religion (*Deen*), life (*Nafs*), intellect (*Aql*), lineage (*Nasl*), and wealth (*Mal*)[9]. That is to protect the man of his own mischief. It is clear the moral values is taken into consideration by the Islamic law and if in whatever situation these objectives are not fulfill comprehensively, simultaneously, and collectively the life will become chaos.

The 1997 economic crisis showed the dark side of the picture where businesses went bankrupt, banks were in trouble of non-performing loans, ordinary people on the verge of being broke or being broke, and whole economy in the slump. The unconventional treatment of Tun Dr. Mahathir with the problem led to saving the economy from being

[7] Rosly 2005, p 363.
[8] Ibid
[9] Ibid

controlled by IMF or World Bank. The need for scrutinizing the whole process of the financial system was apparent and different schools of thought in analysis the cause of the crisis adopted many theories. Malaysia was one of the leading counties in adopting an Islamic index in its system.

Therefore, Islamic market is not to exist based on the free will, rationality, and morality of a human being alone but with the regulation by the authority (i.e. sources of Islamic laws) when needed. This will be fulfilled by investing in capital market not merely for profit but to fulfill the obligation of cooperation where both parties as well as the society will benefit. The question arise when, in a situation like a crisis where everything is going down how would a Muslim investor react in such a way which will not inflict harm on others. What is meant by cooperation in buying and selling stocks is not as it is perceived but to look for stock that are not against Shariah and at the same time will help others in the society.

An example of such would be to invest in companies that do not produce externalities, weapons, alcohol, and so on. In other words, the investor should seek investment portfolio that will have benefits to others as well as himself or herself.

1.2 Research Objectives

This dissertation is divided into three main parts. The first part deals with comparing the performance of KLSI and KLCI. This part investigates three objectives. First objective is whether there is a difference in returns between these indices. Based on the theory of modern finance, Rudd (1981), Teper (1991), Johnson and Neave (1996), and Langbein and Posner (1980) asserted that screened investment portfolios yield lower returns due to under-diversification, and higher monitoring and administrative cost. Since the main goal of any rational investor is to minimize cost and maximize returns, the higher costs should be compensated by higher returns. However, screened investment portfolio is incurring extra costs due to its nature rather than to market forces. In terms of under-diversification, a screened investor has relatively smaller pool of stock to invest. Both investment portfolios producing the same returns mean that there is no effect of extra cost and under-diversifications.

Second objective of this part is to investigate whether these indices are cointegrated. Reyes and Grieb (1998) asserted that if both indices are cointegrated this indicate that the screening act does not cause the screened investment portfolio behavior to diverge (to be different) from non-screened investment portfolio. The cointegration of the screened and non-screened investment portfolio indicates that they co-move in the long run, and the performance of one is useful in predicting the other. This indicates that investor is indifferent between screened or non-screened investment portfolio since they move in the same direction and each of them indicate performance of the other.

A third issue in this part is to analyze whether these screened investment portfolio and non-screened investment portfolios cause the movement of each other or not. Cointegration, if found, indicates that there exists at least a unidirectional causation between two series, however, this cannot be seen except after performing causality test. The purpose of doing causality is to see whether screened investment portfolio causes non-screened investment portfolio or the other way around. Critics of screened investment portfolio suggest that non-screened investment portfolio has a higher returns since it is well diversified it can be concluded that the non-screened investment portfolio may or may not cause screened investment portfolio to move but not the opposite. In other words, non-screened investment portfolio might cause screened investment portfolio since it has access to all available shares in the market, or it might not cause screened investment portfolio since screened investment portfolio concentrated on certain shares that are not influenced by the non-screened investment portfolio movement.

The second part of this thesis deals with the reaction of both KLSI and KLSI to selected macroeconomic variables. The first objective is to investigate whether there is cointegration between KLSI and the selected macroeconomic variables. Hickman et. al. (1999) indicated that the lower the correlations of returns between securities, the higher the reduction of risk. Therefore, a well-diversified portfolio will be affected by economy-wide risk or market risks. The second objective is to investigate whether both indices react similarly to the same selected macroeconomic variables.

The third part of the thesis deals with the reaction of both non-screened firms and screened firms to selected firms' specific variables. An empirical analysis is carried out to investigate whether there is a difference in returns between screened and non-screened firms that are facing the same firm specific variables. The second objective is to investigate whether both screened and non-screened firms react similarly to the same selected firms' specific variables.

Several techniques are used in investigating the above-mentioned issues. Time series techniques are used in the first and second parts of the study, since they are using time series on daily and monthly data. The third part on the other hand uses panel data techniques. This is because in the third part both cross-sectional along with time series data are used to investigate the issues.

1.3 Research Questions

Theoretically, the value of any investment portfolio is determined by the present value of the investment portfolio's expected future cash flows. Subsequently, a rational investor maximizes his utility by maximizing his wealth and minimizing risk. A rational investor who wants to maximize his utility will choose the highest possible return for a given level of risk which can be achieved by constructing a well-diversified portfolio. This applies to both screened and non-screened investment portfolio. However, Rudd (1981), Teper (1991), Johnson and Neave (1996), and Langbein and Posner (1980) argue that screened investment portfolio brings lower expected returns than unscreened investment portfolio. Besides having a less diversified portfolio, screened investment portfolio is more expensive to administer and monitor than unscreened investment portfolio. For example, not all stocks listed on the stock exchanges are permissible for Muslims. Investing in Islamically compliant stocks is different from the conventional stocks as it is heavily based on the Islamic principles of transactions (*Mu'amalat*). These principles are laid by the Shariah Supervisory Board, which determines the criteria of stocks that are Shariah compliant. These criteria in turn are used as guidelines in selecting stocks to be included in Kuala Lumpur Syariah Index. This shows that the investment portfolio has to go through a strict screening process. Whether the stringent screening process affects the relative return on investment portfolios in Syariah compliant securities is an interesting research topic that this study hopes to explore empirically.

The first part attempts to answer three questions. First question is whether there is a difference in returns between KLSI and KLCI indices? Second question is whether there is long run equilibrium between both indices, or whether both indices are cointegrated? The third question is what kind of causality exists between the indices?

The second part attempts to answer two questions. First question is whether there is long run relationship between the selected macroeconomic variables and the KLSI? Second question is whether both indices react differently to similar selected macroeconomic variables?

The third part attempts to answer two questions. The first question is whether there is a difference in returns between screened and non-screened firms? The second question is whether both type of firms react differently to the same selected firm specific variables?

1.4 Significance of the Study

Islamic finance is gaining momentum all over the world. There are many studies examining the performance of Syariah compliant investment portfolio and comparing them to non-Syariah compliant investment portfolio. However, to the researcher's knowledge there is no study investigating the long and short run dynamics of KLSI with KLCI, as well as the macroeconomic variables and firm specific variables and their impact on both types of investment portfolio. Therefore, this study is the first to investigate such issues. The outcome of this study will help scholars to understand whether the screening criteria implemented in the Malaysian index has an effect on its performance. Since in Malaysia the screening criteria are less strict than in other countries that have Islamic indices, this study gives an insight whether this has any impact on the performance. The significance of the first part of this study is with regard to the risk and returns of KLSI as compared to KLCI. Investors are usually concerned about the future cash flow of their investment portfolio. Since it is theoretically implied that screened investment portfolios tend to yield lower returns and higher risk, as argued by Rudd (1981), Teper (1991), Johnson and Neave (1996), and Langbein and Posner (1980), the result in this study give the investor an idea about the risk and returns they face if they choose to invest in screened investment portfolio. Therefore, this study shows investors whether there is any penalty in investing in screened or Syariah compliant investment portfolios or not. The second part is concerned with the macroeconomic variables impact on KLSI and KLCI. The result will indicate whether both indices react similarly to the selected factors as well as it will show whether these two indices are cointegrated which means that the act of screening does not have any impact on KLSI. In addition the Granger causality will show whether these indices spur economic growth, are good hedges against inflation, and whether these indices are affected by the external shock in commodity markets.

The last part of the study contributes to the theory of finance by investigating the firm specific factors affecting both KLSI firms and non-KLSI firms. The findings in this part help investors to decide first whether there is a difference in returns between these firms. Second, the findings will indicate what factors each investor should consider when picking up companies to invest in. Third, the findings of this part will be compared with the previous study in developed and developing markets on the reaction of returns to each factor. Moreover, this part will show whether the screening criteria employed in Malaysia has any effect on the significance of these factors.

1.5 Organization of the Study

The study is organized in the following manner. Chapter 2 discusses the theoretical background of screened and non-screened investment portfolios. Chapter 3 summarizes the existing literature on performance of screened and non-screened investment portfolio, the impact of macroeconomic variables, and the impact of firm specific variables on non-screened investment portfolio. Section 4 describes the methodology, sampling, and data collection for the three parts. Section 5, 6, and 7 present the empirical results for the three parts respectively. Finally, Section 8 concludes the dissertation.