

CHAPTER 1

INTRODUCTION

1.1 BACKGROUND

Unit trust or mutual fund is one of the many financial products in the Malaysian financial market. However, compared to the other developed countries such as Japan, United States, and Australia, Malaysia has a relatively underdeveloped unit trust industry.

A fund is "mutual" in the sense that all of its returns minus its expenses are shared by the fund's unit holders. Investors have a basic choice: they can invest directly in individual securities, or they can invest indirectly through a financial intermediary. A financial intermediary gathers savings from consumers and invests these monies in a portfolio of financial assets. A mutual fund is a type of financial intermediary through which savers pool their monies for collective investment primarily in publicly traded securities. Other types of financial intermediaries include commercial banks, insurance companies, and pension funds.

Most investors are seeking to maximize their returns and minimize their risk, but this combination is not easy to achieve. In general, there is a strong positive relationship between risk and return. In order to achieve higher returns an investor generally needs to take higher risks. Although there are many different types of risks associated with securities investing, analysts typically think of securities as having two main types of risk: risk that stems from the market in general and risk that is specific to the individual company. The latter, known as company-specific risk, can be substantially reduced through diversification- a benefit of mutual fund investing.

In Malaysia the level of awareness among investors in investing in unit trust is still low. Until June 30 2001 the Net Asset Value for overall industry is only about RM41 billion representing 10.2% of the KLSE market capitalization. Hence, as a whole, unit trust is not yet fully optimized as an efficient financial intermediary. (For the details please refer to appendix 1).

Likewise other financial industries such as banking and insurance, unit trust industry also offers Islamic product as an alternative to the existing conventional systems for investors. This is a good measure taken by the Malaysian government, and private fund managers which provide as an opportunity to those who are interested to make gain through this intermediary which is aligned with *Syari'ah* principles.

The Islamic unit trust has only started to operate in 1992, with the establishment of the Tabung Ittikal Arab Malaysian managed by the Arab Malaysian Unit Trust Berhad. Since then we have witnessed an encouraging growth in the Islamic unit trust industry. However, the size of the fund is still very small compared to overall unit trust industry.

Until June 30 2001 there were 18 Islamic funds in the market with a total net asset worth of about RM 2 billion. This figure represents only about 4.7 percent of the total net asset value of the unit trust as a whole. Compared to the KLSE's market capitalization, it is only a minuscule 0.48 percent. (For the details please refer appendix 2).

Besides the smaller size of Islamic unit trust compared to the conventional unit trust, the level of acceptance or optimization of the fund is also quite low. This can be found from the difference between total approved fund size and total units in circulation. For example on June 30 2001, the Islamic unit trust has lower utilization level compared to the conventional unit trust with 62 percent compared

to 67 percent for the latter. This situation portrays that Islamic unit trust is less accepted by investors compared to the conventional unit trust.

We believe that there must be explanation regarding this situation. Malaysia as an Islamic country should take appropriate actions concerning this matter so that the Islamic financial product especially unit trust will receive greater acceptance among investors and general public.

1.2 ISSUES

From the figures mentioned above, we can see that the Islamic unit trust is still lagging far behind conventional unit trust especially in terms of size of funds. Such phenomenon is also prominent in banking sector in which the Islamic product is still in a marginal volume.

The research is basically done to determine what are the contributing factors behind the low acceptance of Islamic unit trust. Factors such as similarities and differences between the two systems will be discussed to ascertain whether it will effect its performance or otherwise. In the real world, lots of people believe that Islamic financial products including unit trust have lower profit and dividend payout. Beside that the success of its implementation is highly dependent to government and Muslim community's supports. Hence, according to them, the Islamic products is not as viable as conventional product in which the conventional system offers better products for them to invest in order to get higher return and superior performance.

To comprehend the factual, the research is carried out to confirm whether the statement is fundamental or otherwise. In addition this research also try to propose several actions that can be taken by the government to promote the Islamic unit trust as in line with country Islamic approach.

1.3 OBJECTIVES OF THE STUDY

The objectives of the study are as follows:

- i. To clarify the Islamic and conventional unit trust concept, how it is developed and how it works. In addition, the advantages and the disadvantages of investing in unit trust are also determined.
- ii. To determine the similarities and differences between these two types of unit trust. At the same times the basic Islamic principles that differs from the conventional products is emphasized.
- iii. To evaluate the performance of both types of unit trust that are currently traded in the market. Besides that, the performance of the funds will be compared to unveil which type of fund performs better.
- iv. Based on the findings from the comparative analysis, recommendations are given to solve any discrepancies.

1.4 SCOPE OF THE STUDY

The scope of the study is about the comparative analysis of the Islamic and conventional unit trust in relation to their performance. To achieve the above-mentioned objective, two samples of selected unit trust representing two types of unit trust (Islamic and conventional) are analyzed. Evaluation of the performance is based on its return and Sharpe Index. In addition, the unit trust's risk that is represented by standard deviation and beta is also determined. Due to the

diversification as an important criterion in investing in unit trust funds, the R square (R^2), which represents the level of diversification of a unit trust fund, is also computed.

Before the differences and similarities of the two systems are revealed, the Islamic principles concerning unit trust will be discussed. This will be an important part because only after fulfilling all the said requirements, a unit trust can be considered as a permissible fund. Then, based on the principles and concepts of the Islamic unit trust, discussion about the similarities and differences between the Islamic and conventional unit trust will be carried out.

1.5 LIMITATIONS OF THE STUDY

The performance evaluation that is carried out is based on historical data covering three years period from January 1 1998 through December 31 2000. Thus, only unit trusts that are established before 1998 are included in the sample.

Besides, only Sharpe Index is employed in measuring the performance of unit trusts in the samples. The other index such as Jensen and Treynor is not incorporated. Hence, the results do not show the differences between Sharpe with other methods of performance measurements. In addition, only one benchmark is used that is EMAS (Exchange Main Board All Stocks) Index.

1.6 ORGANIZATION OF THE STUDY

The study comprises of five chapters that discusses several elements within their own respective scope.

Chapter 1 is the introduction of the study and explains briefly about this research background, issues which lead towards the conducting of this research, its objectives and the organization of this study.

Chapter 2 is the literature review, which highlights the discussion of the concept and the Malaysian unit trust industry, Islamic principles relating to unit trust, the similarities and differences between the two types of unit trusts and some past studies. The past studies regarding performance measurements which is discussed includes local and international research. Since the unit trust concept as well as similarities and differences are explained in this chapter, the first and second objective are already fulfilled.

Chapter 3 discusses the hypothesis of the study and research methodology. This chapter describes the sample selection, data collection techniques, and data analysis techniques in the study. Several formulas are also shown to make the analysis techniques clearer.

Chapter 4 shows the results after the selected samples were analyzed. The results are interpreted to confirm whether the null hypothesis or the alternative hypothesis should be rejected. From this chapter we can also see which unit trusts perform better compared to the other. Thus, based on the clarification obtained from this chapter the third objective is achieved.

Chapter 5 concludes the study and proposes some recommendations based on the findings. The findings and recommendations might be useful for future research, especially for studies in the similar area. This chapter meets the last objective mentioned.