CHAPTER 2
LITERATURE REVIEW

2.1 UNIT TRUST INDUSTRY

2.1.1 Concept of Unit Trust

Basically unit trust is a pooled investment plan in which capital from individual investors is combined into a legally form trust fund. The money is then invested by professional fund managers acting on behalf of investors in a portfolio of marketable securities. In return of their money, investors get stakes called units in the fund in direct proportion to the amount of money they contributed. It is an investment fund collected from the public to invest in shares and other financial securities. It is also a medium in which small investors using a small amount of money can participate in a diversified portfolio of investment, which could not be possible if investors were to invest individually. The diversified portfolio enables investors to reduce risks. The investors or unit holders may enjoy income from their investments in the form of distribution and capital appreciation.

A unit trust is made up of a set of relationships between unit holders who buy units in a unit trust fund, the trustee who is an independent body whose role is to oversee the rights and interests of unit holders and to hold and keep custody of the assets of the fund, and the manager who is responsible for the promotion, administration and operation of the fund. (Appendix 3)

2.1.2 Type of Unit Trust Fund

1. Growth funds

These funds tend to invest heavily in "emerging companies" to assume significant risks to obtain stocks that are expected to provide substantial prices appreciation or give promise of showing steadily rising earnings records that encourage large price earning ratios.

2. Income funds

Investment in common stock, preferred stock, and bonds that pay good cash dividends and coupon interest is the objective of income funds. Risky stocks offering higher potential capital gains tend to be avoided in favor of "blue chip stocks". Although they are somewhat out of favor with common stock investors, they have become more popular with persons seeking current income- generally the retired or well to do without salaries or wages. This group has turned to bonds and debentures, which give substantially greater returns.

3. Growth and income funds

These funds seek to combine long term capital growth and current income. In order to achieve the objective such funds invest in the common stock of companies whose share value has increased and that have displayed a solid record of paying dividend.

4. Balanced funds

Balanced funds divide their holdings between fixed income and low-risk common stocks in order to avoid the risk of loss due to the future that is hardly predictable. Balanced funds seek to maintain certain levels of speculative and conservative common stocks and different classes of fixed income securities. If the stock market goes up, the common stock part of the portfolio will rise with it. If the market goes down, the "defensive" part of the portfolio that is the bonds and preferred stock will produce income and shield shareholders against serious losses. These highly risk averse funds usually have low rates of return.

5. Saving funds

The objective of the funds is to achieve steady growth in income over medium to long-term investment in the strong economic growth of the country. For example, monthly deduction scheme from individual saving account to invest in this fund.

6. Islamic funds

This type of fund invest in a portfolio of equities and debt securities which comply with the principles of *Syari'ah* in order to provide a balanced of income and potential capital growth. The fund will be managed strictly in accordance with *Syari'ah* principles under the advice of the Syariah Panel which has also establish principles for deducting income derived from activities which not in compliance with *Syari'ah*. Such amounts will be donated to charities specified by the Syariah Panel.

7. Bond funds

Bond funds are investment trust with the objective of lending money to industries, utilities, states, cities or other public bodies. Some such funds try to invest in issues that permit conversion into common stock. If the latter rises they get not only reasonably assured income but also capital gains as their holdings rise with the common stock. However, these funds also invest in the corporate bonds that have low bond quality rating to earn high interest rates.

8. Equity Index funds

Equity index funds focus on index-linked stocks of a selected benchmark market index usually KLSE Composite Index. The funds invest in diversified portfolio of component stocks of a selected benchmark market index in its efforts to replicate the Composite Index's composition and performances.

2.1.3 History of Unit Trust in Malaysia

The unit trust industry is still new in Malaysia as compared to other developed countries such as United States and United Kingdom. It was started about two years after independence. The development of the unit trust industry in Malaysia can be divided into three stages:

First stage (1959-1980)

This stage was an introduction phase for the unit trust industry in this country. It was started in 1959 when the English investors in Singapore established the Malayan Unit Trust Limited in which the Unit trust of Malaya was managed. However, in 1963 the unit trust was transferred to the South East Asia Development Corporation. Following the separation of Singapore from Malaysia in September 1965, the above unit trust was split into two where the Singapore Unit Trust was based in Singapore and the Asia Unit Trust was based in Malaysia.

In 1967 Amanah Saham Mara Berhad was established as the first Bumiputra owned management company to promote the involvement of Bumiputras in the industry. Its first fund, which was named as the First (MARA) Bumiputra Investment Fund was launched in 1968.

The first state fund manager, Amanah Saham Pahang Berhad, was established in 1976. However, the industry remained insignificant until the end of 1980 with only five managing companies managing twenty-one unit trusts totaling 75.9 million units with a value of RM 162.00 million.

Second stage (1980-1990)

The development of unit trust industry became much more significant only after 1980 due to the introduction of Amanah Saham Nasional Berhad (ASNB) and its parent company, Permodalan Nasional Berhad (PNB). The public sector unit trusts dated back to 1979 when the government decided to use unit trust as a vehicle by which the shares of Malaysian enterprises were distributed to Bumiputras to accomplish one of its New Economic Policy goals that is to increase Bumiputra share holdings up to 30% by 1990. PNB was established in 1978 as a wholly owned subsidiary of the Bumiputra Investment Fund (Yayasan Pelaburan Bumiputra).

In April 1981, the industry was given a boost with the setting up of the Amanah Saham Nasional (ASN) scheme, which has been managed by ASNB. This trust fund with an initial issuance of 540 million units and government backing, not only shows the overall size compared to the other existing funds, but also expanded rapidly to become the nation's premier unit trust fund, with a size of 11 billion units valued at RM 10.8 billion at the end of 1990.

The ASN units were transacted under a fixed price scheme irrespective of the market value of shares held by ASN. Such an arrangement expired on December 31 1990. In order to provide a continuing opportunity for Bumiputra individuals who still prefer a fixed price, the Amanah Saham Bumiputra (ASB) unit trust fund was established in October 1989. The ASB scheme became operational on January 1, 1990 and investors were allowed the option to transfer their ASN units to the ASB. Both Bumiputra funds constitute 90 percent of the total fund in the industry as at June 30 1994.

During this stage the unit trust industry has developed rapidly. Financial institutions were attracted to get involved in the unit trust industry following the success of the ASN scheme. In 1982 AMMB Asset Management Sdn.Bhd, a joint venture company owned by Arab Malaysian Merchant Bank Berhad and Macquarie Bank Limited, was established to manage the unit trust funds on their behalf. In addition to the above, Bank Bumiputra Malaysia Berhad had also established its own unit trust management company in 1988.

Third stage (1990 until now)

During this stage, we can see that the state sponsored funds became more significant following the enormous success of the public sector trust. In fact, all the state funds that are currently traded in the market such as Amanah Saham Johor, Amanah Saham Selangor, Amanah Saham Sarawak, Amanah Saham Kedah and others were launched after 1990.

In addition to the above, a lot of financial Institutions have also set up their fund management companies in order to grab the opportunity to collect public deposits through numerous funds. As examples we have Kuala Lumpur Mutual Fund Berhad that has set up eleven unit trust funds, BHLB Pacific Trust Management Berhad and Commerce Trust Berhad have set up seven funds each, and AMMB Investment Services Berhad and Asia Unit Trust Berhad have set up six unit trust funds each.

The catalyst that has contributed towards the rapid development of the unit trust industry in this stage was the establishment of Securities Commission in March 1993 to monitor and to ensure the healthy development of the industry. In addition, the Federation of Malaysian Unit Trust Managers, which was formed on August 7 1993, has also contributed significantly towards promoting the unit trust industry as a whole.

Until now the government-sponsored trust funds represent the vast majority of funds under management, however the growth rate of number of approved funds under private management is greater than the former. The details of the profile of the Malaysian unit trust industry from 1993 through 2000 is shown in table 2.1

Table 2.1 Profile of the Malaysian Unit Trust Industry

	1993	1994	1995	1996	1997	1998	1999	2000
ustry								
of companies	16	20	27	30	31	32	34	34
of approved funds	44	52	67	77	84	95	107	127
proved fund size (bill units)	18.672	28.814	37.363	47.105	55.515	61.88	74.351	90.351
ts in circulation (bill units)	17.029	25.122	31.938	38.983	45.25	46.54	52.632	63.846
asset Value (RM bill)	28.134	35.716	47.268	59.955	33.573	38.73	43.257	43.299
blic Funds								
. of approved funds	20	24	26	27	27	28	30	30
its in circulation(bill units)	15.923	21.008	25.658	31.595	35.916	35.51	37.104	40.201
t asset Value (RM bill)	26.699	31.678	41.64	52.888	28.612	32.33	32.199	30.544
ivate Funds								
. of approved funds	24	28	41	50	57	67	77	97
its in circulation(bill units)	1.106	4.114	6.28	7.388	9.334	11.03	15.528	23.645
et asset Value (RM bill)	1.435	4.038	5.628	7.067	4.961	6.4	11.058	12.755

As mentioned in the first chapter that the Islamic unit trust was introduced during this stage with the establishment of Tabung Ittikal Arab Malaysian, managed by AMMB Investment Services Berhad. Since its commencement in 1992, the Islamic fund has been growing tremendously from only 500 million units approved in 1992 to more than 6 billion units currently. The number of the management companies in operation has also increased to eighteen. From the table 2.2, we can see the yearly development of the Islamic fund and the conventional fund from 1998 through 2000 as a comparison.

Table 2.2 Yearly Development of Islamic and Conventional Fund

Year		Islamic	Conventional	Total
1998	No. of Fund	13	82	95
	Unit in circulation (billion)	1.684	44.856	46.54
	NAV in RM (billion)	0.84	37.89	38.73
	NAV to KLSE capitalization	0.22%	10.11%	10.34%
1999	No. of Fund	13	94	107
	Unit in circulation (billion)	2.117	50.515	52.632
	NAV in RM (billion)	1.39	41.867	43.257
	NAV to KLSE capitalization	0.25%	7.58%	7.83%
2000	No. of Fund	17	110	127
	Unit in circulation (billion)	3.133	60.713	63.846
	NAV in RM (billion)	1.683	41.616	43.299
	NAV to KLSE capitalization	0.38%	9.36%	9.74%

In general, this pattern of growth in unit trust industry is likely to continue since the level of market penetration of the unit trusts in Malaysia is still quite low compared to developed countries such as the United States, Japan and Australia. This positive trend provides a very healthy future outlook for the Malaysian unit trust industry as we start to approach international levels of market awareness and investment.

2.1.4 Advantages and Disadvantages of Investing in Unit Trust

Like any other financial product in the financial market, unit trust has its own advantages and disadvantages. The advantages and the drawbacks will be briefly explained as the following:

2.1.4.1 Advantages

1. A unit trust allows the smaller investors to participate in a wide range of securities, thereby spreading the investment risk. A small capital outlay can be invested in as many different counters or sectors in the stock market.

2. The unit holders also benefit from experienced fund managers who are not only managing the funds but also keep track of all the proper records. The value of the units directly reflects the value of the underlying assets. In the falling market trend, the value of the unit may well go down along with the share prices in general. However a good manager should be able to limit the fall in the price of the units. He should perform better than the KLSE Composite or EMAS Index.

3. By investing in unit trust, investors will acquire returns, from the income received by the fund. The return will either be distributed as annual or semiannual dividend or as a capital gain resulting from redemption of units.

4. Another advantage is the liquidity offered to investors. They can choose to liquidate their position either partially or completely with the managing company on any business day without much fuss.

5. Management companies must abide by a set of rules and regulations governing the trusts as stated in the trust deed. It is important to make sure that all the action taken by management companies is aligned with the investors' interest.

6. The authority has set up rules and regulations and these are clearly stated in the "Guidelines on Unit Trust Funds" so as to protect the interest

of investors and providing directions for the industry's development. The contents of the guidelines cover scope of investment, functions of the trustee, functions of the managers, and other provisions such as the line of communication with the unit holders.

2.1.4.2 Disadvantages

1. Investors have to pay management cost when they buy the unit trust fund. The price difference between the buying price and selling price in Malaysia is about five percent, which is classified as the management cost to be paid to the unit trust companies. Such cost may "eat up" the returns of the investors.

2. Unit trusts are medium to long-term investments that are about 3-5 years investment before investors realize the returns. So, if the investors want to liquidate their money in one-year period, they may end up making a loss in their investment.

3. Most of the unit trust fund cannot beat the buy and hold strategy (market return) as shown in previous studies.

2.2 *MU'AMALAH*

Islam as *al-Din* embraces every single aspect of daily life. The perfections of Islam can be seen through its comprehensive laws and regulations (*al-Syari'ah al-Islamiyyah*) that govern a Muslim's life in every aspect. Essentially, within the context of the human life, *al-Syari'ah al-Islamiyyah* can be classified into 3 main components namely *'Aqidah, Syari'ah* and *Akhlaq.*

'Aqidah relates to the belief towards *Allah (s.w.t.)* and the piousness of the believer. On the other hand, *Akhlaq* concerns both the ethical & moral matters confronted by human beings. The final component, *Syari'ah*, touches on the practical aspects of any activity in everyday life. *Syari'ah* itself comprises of two elements, which are *'Ibadah* and *Mu'amalah*. *'Ibadah* relates to practices devoted to *Allah (s.w.t.)*, whereas *Mu'amalah* involves the relationship between human beings for their benefit. Hence this classification implies that any transaction, whether contract or practice, which is involved in the affiliation between people with mutual interests is known as *Mu'amalah*.[1]

2.2.1 Islamic Unit Trust

The Islamic unit trust, which is also known as Syariah fund, apart from as a subset of the unit trust industry as a whole, is also an important component of the overall Malaysian Islamic financial and economic system. It is viewed as a religious responsibility of each and every Muslim to participate in efforts to create, develop, sustain, and make a success of the Islamic financial and economic system; as a comprehensive and viable alternative to the conventional system.

The existence of the Islamic funds enables the Muslim community (*Ummah)* to come together to pool their investment resources. This promotes collective responsibility and collective effort (*Muafakat*), a characteristic of society demanded by tenets of Islam. The investments parameters of the Islamic unit trusts are dictated by the Islamic law (*Syari'ah)*. Therefore, the Islamic unit trust in more ways than one, is an "ethical" product or investment vehicle. It allows the Muslim investor to fulfill both his religious and investment needs. We therefore conclude that the development of and participation in the Islamic unit trusts are more than just finding a place to put our money, but also if accompanied by a suitable intention (*Niyat)* it is elevated to religious responsibilities (*'Ibadah)*.

Islam is not exclusively for certain groups of people. Nor is it just suitable for a certain time period. Islam is a way of life for everybody and for an infinite time. From an Islamic perspective, in terms of *Mu'amalah* - everything is acceptable (*Halal)* unless proven otherwise by either the *Quran* or the *Sunnah.*[2]

Every Islamic financial and banking activity must be aligned with regulations determined by *Syari'ah.* The general principles in *Mu'amalah* can be summarized as follows:[3]

i. Every transaction must be completed based on the willingness of both parties involved.

ii. Every party involved must fulfill all the necessary criteria, whereas the contract formed must not be degraded by anything that can invalidate it, for example duress, misrepresentation and mistakes.

iii. The goods (objects upon the contract) must be well known in terms of its type, characteristics, volume, and whether it can be delivered. The goods must bring benefit and considered to be sacred through the Islamic point of view.

iv. It must be free from *Riba* (usury), *al-Qimar* or *al-Maysir* (gambling or game of hazard), *al-Gharar* (risk and uncertainty) and any prohibited dealings.[4]

v. It must be free from elements of oppression such as *al-Ihtikar* (concealment), an extreme profit that leads to excessive loss incurred by the other contract parties (*Ghabn al-Fahisy*), the blockage of products from accessing the open market (*Talaqqi al-Rukban*), and other prohibited transactions.

Since a unit trust does not disagree with any Islamic law, it is permissible for Muslims to expand their fortune.

In order to analyze how a fund is managed from an Islamic point of view, the implementation of a unit trust is classified into several *Mu`amalah* principles:[5]

1. The contract of sale and purchase *(al-Bay')*
2. The *Musya'* Assets concept
3. The representative concept *(al-Wakalah)*
4. *'Uqud Ghair al-Musamma*

2.2.2 Sale And Purchase Contract

Islam views the process of buying and selling a unit trust as falling under the contract of sale and purchase. The contract occurs within either a verbal or a written context and is taken as proof of the existence of a transaction. Thus, when an investor fills up the purchasing or reselling form, at that point in time the contract of exchange is taking place. According to the Islamic law, price changes do not hinder the contract from being acceptable. Furthermore, the certificate provided represents ownership of the investment.

2.2.3 *Musya'* Asset Concept

The concept of *Musya'* asset consists of various types of assets arising from various transactions. These transactions may originate from different sources or sectors. In accordance with such a concept, a unit trust is considered as a type of *Musya'* asset since it invests in various stocks. The shares can be purchased in a selected denomination. This means the transaction is clear and determined. Such characteristics are in line with the *Musya'* asset concept in Islam.

2.2.4 *Al-Wakalah* Concept

According to the trust deed agreed by both parties, a fund manager is seen as a representative to the unit holders and is in charge of handling the fund. The management can impose service fees that do not exceed 10% in respect of the funds' units, and management fees of not more than 1.5%. In *Mu'amalah*, such practices can be categorized as the *al Wakalah bi al Ujar* concept.

Al Wakalah means representing or replacing others whereby the person being represented is still alive. In this sense it involves custody and handing over a person's right to another person.

Since earlier times people have depended on a representative to accomplish several tasks on their behalf. This occurred either out of necessity or due to the individual's own inability to carry out such a task. An example would be a minister who has been entrusted by the people to execute their needs or a fund manager that represents the capital investors in managing the fund.

Due to these needs Islamic law approves *al Wakalah* based on the following translation of the *Quranic* verse:

" ......So send one of you with this silver coin of yours to the town, and let him find out which is the good lawful food, and bring some of that to you..."

(18:19)

Furthermore the *Sunnah* narrates that the *Rasulullah (s.a.w.)* made *Hakim Ibn Huzam* or *'Urwah al-Bariqy* as a representative in purchasing sheep for the *Qurban* (sacrifice).

Al Wakalah can be with or without pay. When an *al Wakalah* contract is followed by payment, the contract is valid and binding (the representative has to accomplish the required task). Whereas if nothing is given, the representative can freely terminate the contract at his or her willingness.

Al Wakalah is divided into 2 categories, which are *al Wakalah al 'Ammah* (general representation) and *al Wakalah al Hassah* (specific representation). The former means the representative has the right to carry out a wide range of tasks without specific restriction. For instance A says to B, "Be my representative in any circumstance" or "Please buy anything for me".

The latter means a representative is subjected to a certain determined task. For example someone that represents another person in purchasing a specific vehicle or residence. He or she does not have the right to act over his or her designated responsibilities, such as choosing a different type of vehicle or determining the price that will be paid for the procurement. [6]

In today's current situation there are no products that fall directly under any cited category including the unit trusts. As a representative of unit holders, a unit trust manager is dependent on the conditions and responsibilities determined in the trust deed that are neither too broad such as *al Wakalah al 'Ammah* nor too confined such as *al Wakalah al Hassah*.

Thus, in terms of freedom, a representative or *al Wakil* cannot be involved in any activity that is against the guidelines determined in the trust deed. Representatives should also abstain from using the fund for their own interests and should be held responsible for losses incurred due to their carelessness unless the losses were caused by otherwise.

2.2.5 *'Uqud Ghair al Musamma*.

The unit trust activities are basically derived from the supply of capital from different types of investors. Sharing is based on the proportion of capital contributed in the unit trust and not based on the degree of involvement in operation. On the other hand, we have qualified executives that manage the company.

The question is whether a unit trust can be classified as one of the two basic Islamic partnerships namely *al Mudarabah* and *al Musyarakah* or neither one. As far as *al Mudarabah* is concerned, the agreement is between at least two parties, one being a lender or sometimes known as an investor and the other an entrepreneur. This means the entrepreneur must generate profit by joining profitable businesses using the fund lent by the investors. He or she must directly involve himself or herself in managing the business that has been setup. This direct involvement is known as *Syakhsiah Tabi'iyyah*.

Such an involvement is not exclusively stipulated in *al Mudarabah* but also in *al - Musyarakah* in which both parties must be involved in core businesses that have been agreed upon. Based on this argument, we conclude that a unit trust operation is not completely in accordance with *al Mudarabah* or *al Musyarakah*.

Apart from the *Mu'amalah* principles that were discussed in the *Quran*, the *Sunnah*, or by Islamic scholars, there are actually certain aspects that are left to *`Uruf* (current practices that are consistent with current needs). Any new contract that has not been mentioned before is named as *'Uqud Ghair al-Musamma* (contracts that are not being determined).[7]

2.3 A COMPARISON BETWEEN THE ISLAMIC AND THE CONVENTIONAL UNIT TRUSTS

In actual fact there are many similarities as well as differences between these two systems. The introduction of the Islamic unit trust, which came into picture later than the conventional one, contributes to similarities between these two systems. This is because the Islamic unit trust adopts several values, aspects, and concepts in the conventional unit trust, which are not in contradiction with the Islamic principles.

However, as a result of several elements which are not in line with the Islamic principles, especially in terms of implementation of the conventional systems, the

Islamic unit trusts has introduced a new method that concurs with the principles of *Syara'*.

The similarities and differences will be briefly explained as the following:

2.3.1 Similarities

2.3.1.1 Management Company

The managers of the unit trusts (management companies) provide investment and administrative expertise, as well as market units to the public. They are the promoters of the unit trusts and are responsible for its overall investment performance.

Each of the funds in the market has its own manager, regardless of whether it is Islamic or conventional. Some of the companies even offer dual fund systems that are both Islamic and conventional, for example the RHB Unit Trust Management Berhad, the ASM Mara Unit Trust management Berhad, and the AMMB Investment Services Berhad.

The appointment of the unit trust managers has to be approved by the Securities Commission. Whereby the trust deed constructs the rules and regulations that the manager must abide by, with regards to promotion of the trust, the day-to-day investment decisions, as well as administrative and accounting requirements. The determination of the unit "buy" (also termed as "entry", "issue", "offer", or "application") price at which units are to be sold and the "sell" (also termed as "redemption", "repurchase", "bid", or "buy back") price of units at which unit holders realize their investment, is another primary role of the manager.[8]

2.3.1.2 Act and Regulations

From the regulatory framework, both the Islamic and the conventional funds are subject to regulations of the same act. Following the Securities Commission Act 1993, all unit trusts are regulated by both the Securities Commission and the Registrar of Companies under the Companies Act 1965. Therefore, the regulation of the unit trust industry requires the cooperation of both the Securities Commission as well as the Registrar of Companies. The Trust and Investment Management Department within the Issues and Investment Division of the Securities Commission is responsible for the regulation of all matters pertaining to unit trusts and other collective investment schemes.

2.3.1.2.1 The Securities Commission

In its role as regulator of unit trust schemes, the Securities Commission (SC) issued a set of comprehensive rules on March 10, 1994 called the Guidelines on Unit Trust Funds. These guidelines supersede the various informal guidelines that existed prior to the date, and were issued with the objective of providing a regulatory framework that would protect the interests of the investing public and facilitate an orderly development of the unit trust industry.

The Guidelines on Unit Trust allows unit trust companies greater flexibility in the management of their funds. It will be issued from time to time based on the current needs. A review of the guidelines was carried out in 1995 to allow for the latest domestic and international developments and practices. This review included the formulation of guidelines on the marketing of unit trusts, code of conduct for fund managers, and disclosure requirements.[9]

However, after enforcement of Securities Commission (Amendment) Act 2000 on July 1 2000, the Securities Commission (Unit Trust Scheme) Regulations 1996 has been repealed, and thus, the regulatory provisions governing unit trust schemes are now contained in the act itself. [10]

Other than that, the Securities Commission also gathers statistics on the unit trust industry to assist it in monitoring the progress of the industry's growth. Based on the data collected, appropriate policies and guidelines can be formulated to ensure the continued growth of the industry without compromising the basic requirement of the investor's protection.

2.3.1.2.2 Registrar of Companies

While all applications for regulatory approval of trusts, including those requiring the approval of the Registrar of Companies (ROC), are submitted through the Securities Commission, the ROC continues to play a significant role in the regulation of the unit trust industry.

The Companies Act 1965, which is administered by the Registrar, affects the unit trust industry in several key areas, the most significant of which are the contents of trust deeds and prospectuses, as well as advertising.

The manager of a unit trust must be a public limited company and therefore many requirements of the Companies Act applicable to companies generally will also apply to the management company.

The management company of a unit trust is required to be a subsidiary of a financial institution, which is supervised by the Bank Negara Malaysia, or by any other institution approved by the Commission. While the management company is an "exempt dealer" under the Securities Industry Act (and is therefore not subject to the licensing requirements described in the act), the Guidelines on Unit Trust Funds require the management company to have adequate financial resources at its disposal to enable it to undertake its functions effectively in order to be approved as such by the Securities Commission.

The Commission specifies that the management company should have shareholders' funds of at least RM 500,000 (where the approved size of the fund(s) is less than 100 million units) or RM 1,000,000 (where the approved size of the fund(s) is 100 million units or more). In addition, the management company should be at least 70% Malaysian-owned with 30% Bumiputra-ownership and foreign ownership cannot exceed 30 percent.[11]

2.3.1.2.3 Federation of Malaysian Unit Trust Managers (FMUTM)

The FMUTM is a body of managers of unit trusts formed to assist in the development of the unit trust industry. The Federation works closely with regulators, particularly the Securities Commission, in the protection of the interests of investors in unit trusts and to promote the growth of the industry.

The federation provides a forum for its members and has organized study visits to the United Kingdom, Hong Kong, and Australia to learn from experiences of these countries in operating their collective investments scheme. Delegates of the SC are invited to attend such visits as part of the Federation's role of assisting in the development and growth of the unit trust industry.[12]

2.3.1.3 Fees

Since the manager of a unit trust plays a role as a custodian upon the collected fund and manages it on behalf of unit holders, fees are charged for their services and expertise. Fees such as an "initial service charge" (also termed as "entry", "front end", or "application") fee which is added to the selling price of the unit trust, and an "annual management" fee which is based on the value of assets in the fund that are charged will be part of the manager's income. From the initial service charge, the manager pays commission to distributors of units (agents or intermediaries) who introduce business to the manager.

Both systems charge unit holders with the same fees within the permitted rate. The fees charged among others include the management fees, brokerage fees, and trustee fees. As far as fees are concerned, Islam allows such fees to be charged to unit holders as long as the fees are not excessively high and oppressive. The rate can be determined based on the current situation and standard of living. The reasonable rate that can be accepted by both parties (the unit holders and the management companies) will lead towards understanding and attracting others to invest in such funds. Besides earning high profit from dividend and capital gain, high involvement in unit trust fund will indirectly support the whole Islamic financial system by transferring excess liquidity from households. Sufficient funds will make efficiency in the Islamic financial system possible.

2.3.2 Differences

2.3.2.1 Philosophy

The Islamic financial system is part of Islam and it binds all activities under the Islamic principles. The Islamic system is dedicated to human brotherhood accompanied by social and economic justice and equitable distribution of income and to individual freedom within the context of social welfare. This dedication is spiritually oriented within the context of social and economic norms. Therefore the freedom of running any business and transaction in an Islamic financial system must not only be based on bottom line consideration but also to uphold the societal needs of the people.

In contrast to that, the conventional financial system is based on the concept of modern capitalism. The concept of social and economic justice and equitable distribution of income resulting from group pressures, is not the outcome of a spiritual goal to establish human brotherhood, and does not constitute an integral part of its overall philosophy. In short, modern capitalism has separated the function of religion in managing the other aspect of human life. The conventional system encourages that any financial decision-making should be based on bottom line considerations. Each individual has the full right on his or her wealth and he or she has the full right to do whatever he or she chooses with the wealth. This principle is enclosed on the basis of the personal achievement and the individual profit making without having much concern about the whole society unless it will benefit his or her personal goal. [13]

2.3.2.2 Concept

A unit trust that is managed under the Islamic system is free from any interest. To enable a unit trust to be categorized as a permissible fund depends on the status of the authorized investment[14] chosen by the management companies. The responsibility to monitor and evaluate as well as approve Islamic unit trust is currently under Syariah Advisory Council of Securities Commission. Every investment chosen must align with determined Islamic principles. In addition to be free from *Riba*, the other negative elements such as *al-Gharar* (uncertainty), concealing, extreme profit and the like should be avoided. For funds or investments that contravene with any Islamic principle, the status of permissibility will be forfeited, and as a Muslim, one should refrain from pouring capital in such investments.

In contrast to the Islamic unit trust, the conventional unit trust is free to invest in any authorized investment regardless of whether the investment is permissible by Islam or otherwise. Since the ultimate objectives of the unit trust are to reduce risk and simultaneously to provide a better return especially to public investors, the conventional unit trust only concerns investment pay off. The higher the return, the better the fund will be. Due to the absence of any restriction, it is quite certain that the conventional funds are more diversified than the Islamic funds.

2.3.2.3 Syariah Panel

Apart from the Syariah Advisory Council (SAC) of the Securities Commission, the board of directors of the management company also appoints a Syariah Panel to monitor and set investment guidelines in compliance with *Syari'ah* principles. As opposed to the SAC that monitor and approve the overall Islamic stocks and investment in the market, the Syariah Panel only concerns the Islamic Funds that are managed by a certain company and which are accountable only to the funds' unit holders[15]. Any company that intends to offer the Islamic unit trust must set up its own Syariah Panel. In general, the appointed members of the panel consists of academicians and practitioners, as well as *'Ulama* (Islamic Scholars) that have astute understanding in regards to the Islamic financial system.

On the other hand with the conventional funds, there is no such body that monitors the portfolio of the fund. Every investment decision is solely made and approved by the fund's management company or external investment management (if any)[16]. Hence, there are no restricted investments for the conventional funds, and the management of the funds freely chooses any authorized investments to be invested in.

2.3.2.4 Cleansing Process for Islamic Funds

The cleansing and purifying of income by withdrawing part of an income or profit is called *Tazkiah*. The income of the Islamic funds and the profits from the sale of securities are cleansed according to the purification process that is determined by the Syariah Panel. This process is carried out to ensure that the income and the profits are "clean". The income and the profits that are cleansed are the portion of the dividend from the *Halal* securities that originate from mixed, non-*Halal*, or doubtful revenues. Furthermore, the dividend issued and the profits from the sale of securities, which have been declared non-*Halal* by the Syariah

Panel but cannot be disposed or sold due to market conditions, in addition to the other kinds of incidental non-Islamic activities are also cleansed out. The amount deducted from the funds based on the above criterion is donated at the end of each financial year to charitable organizations approved by the trustee and the management company, and as agreed upon by the Syariah Panel.

Compared to the Islamic trust funds, the conventional funds do not have a process of that kind to purify their income. All profits from sale of securities or dividends are included as the revenue generated and are distributed to unit holders or retained according to the management company's policy. Donations made by the company are fully dependent on their willingness and there is no corresponding mechanism that obliges the company to give away a portion of their generated revenue.

2.4 Performance Evaluation

The concept of grouping securities into portfolios has important implications for many facets of the investments. A landmark paper, " portfolio selection" by Harry M. Markowitz that was published in March 1952 is accepted as the origin of the modern portfolio theory approach to investing. From his study, it is revealed that combining risky securities into the portfolio rather than holding them individually can reduce the risk, which is measured by standard deviation of return. Besides that, the key to portfolio risk reduction is that the return on most securities is not entirely positively correlated.[17]

The portfolio theory developed by Markowitz illustrates how to measure the risk but does not specify the relationship between the risk and the required rate of return. The risk-return relationship was later developed by John Linter, Jan Moissin and William Sharpe, and is known as the Capital Asset Pricing Model (CAPM). The CAPM relies on the perfect market assumption and specifies that the required rate of return on a risky security is a function of three factors namely risk free rate, the required rate of return on market portfolio and the volatility of the security's return in relation to the returns on the market.

Sharpe studied the performance of thirty-four mutual funds over the period from 1954 to 1963 in the USA. He developed a risk-adjusted measure of performance based on the reward to variability ratio (the Sharpe Index). On the average, the funds could not outperform the market portfolio (the Dow Jones Industrial Average). Only eleven out of the thirty-four mutual funds had higher Sharpe Index value than the DJIA. This means that DJIA is a more efficient portfolio than the average mutual fund in the sample. His result also shows that the differences in performance over time can be predicted although imperfectly, and that no indication on the sources that account for the differences in performance can be obtained. Yet it does not confirm that past performance is the best predictor of future performance. However, when the reward to volatility ratio that is the Treynor Index is used, Sharpe shows that for funds that performed reasonable diversification, the Treynor Index may provide better prediction of future performance than the Sharpe Index. Sharpe also shows that good performance is associated with low expense ratio and that size of fund per se is an unimportant factor in predicting future performance.[18]

Jensen studied the performance of one hundred and fifteen open-end mutual funds for a ten-year period from 1955 to 1964. He developed a performance measure called the Jensen's Alpha for evaluating a portfolio manager's prediction ability of security prices. His study shows that on the average, managers were unable to predict security prices well enough to outperform the naïve " buy and hold" strategy.[19]

Firth studied the performance of seventy-two British unit trusts from 1965 to 1975. The result also indicates that unit trust managers failed to outperform the "buy and hold" strategy even when management expenses are added back. It shows that managers do not have superior forecasting abilities and thus active management does nothing for performance. Firth could not find any consistency in the performance ranking of the funds over the various time periods and also found no difference in performance between the various types of the funds. The systematic risks of the funds are found to be lower than market risks. He also shows that the size of the unit trust, the relative number of investment holdings, the relative numbers of unit holders, age of the fund, initial and annual management charges, liquidity and the beta values have no significant affect on Jensen's Alpha. The beta value cannot also be explained by these variables. It suggests that the beta value of individual trusts depends largely on the investment policies of managers.[20]

Gurney found that there was a weak correlation between the size of a fund and their performance. However, a significant correlation was noted between the yields quoted by the funds in the beginning of the periods and their performance. A positive correlation between performance ranking in the successive years was also found unless market condition changed considerably. However, this could not be generalized to all market conditions.[21]

In the USA, Moles and Taylor conducted a risk return analysis of eighty-six funds for a ten-year period. They found that in most cases, the variables such as number of units, size of funds and historical yield had weak predictive power for the future fund performance and there was little differentiation among the funds in spite of their stated objectives. Even though they found that there are significant relationships between performance and several variables such as growth pattern, level of liquidity and type, no strong relationship was found between performance and other variables like fund charges and management group.[22]

Ippolito studied the performance of one hundred and forty-three mutual funds in the USA from 1965-1984. He found that mutual funds with higher turn over, fees, and expenses, earn rate of return sufficiently high to offset the higher charges.

These results are consistent with the notion that mutual funds are efficient in their trading and information gathering activities.[23]

2.4.1 Empirical studies in Singapore and Malaysia

Koh and Koh analyzed nineteen unit trusts in Singapore from 1980 to 1984. Their findings shows that the return and risk characteristics of the unit trusts in the sample were not consistent with their stated objective in which the growth funds must have higher yield and risk compared to balance and income funds. The funds also do not achieve high diversification and are unable to outperform the market with returns less than risk free rate. The income funds exceed growth and balance funds. The sample of funds are also unable to report consistent performance over time since the Spearman Rank Correlation for the different pair of years is not significant.[24]

In Singapore, the Association for Investment Management and Research (AIMR) has been set up to design standards to ensure fair and complete representation and greater uniformity in reporting investment results. These standards became effective in January 1993 that covered a variety of subjects including the basic of calculating performance return. The standards set up are to assist investors in making comparative analysis or various funds' returns.

Ariff and Johnson studied the performance of fourteen unit trusts in Singapore from 1984 until 1989. They used weekly dividend-adjusted returns and found that there was room for further diversification of the composition of the funds. The fund manager selects low beta stocks for safety as first principle and therefore limits the extent of diversification benefits. Apart from that, they found that overall funds did not do better than the market portfolio, given the transaction cost and economic price for services of pooling and managing the small investor's funds.[25]

Lee, from her study on twenty-one Singapore unit trusts over a five-year period from 1986 to 1990 found that most of the unit trusts failed to beat the market. Based on Treynor index, just one fund can beat the market but based on Jensen and Adjusted Jensen Alpha Index, eight funds do better than the market. However when the funds are grouped according to their objective, income funds are found worst while the special funds (funds that are specialized in certain sectors, industry or commodity) are the best performers. Most of the funds in the sample are inconsistent in their performance for the five-year period. There is no significant difference in the risk profile over time for most of the funds with 38% of the funds showing significant difference in risk. She shows that the funds systematic risk level is quite stable over time although they are not consistent with the fund stated objectives.[26]

Chua did a study on twelve Malaysian unit trusts managed by two management companies covering a ten-year period from 1974 to 1984. The Amanah Saham Mara Berhad manages nine of the funds in the sample and the Asia Unit Trust manages the rest. Based on the study, the Sharpe Index of fund exceeds market value with 0.161 and 0.083 respectively. The Spearman Ranking Correlation values for the Sharpe Index and Treynor Index for the two sub periods of 1974 to 1979 and 1979 to 1984 is significant, indicating fairly consistent performance over time. The unit trusts appear to adhere to their stated objectives and also perform their risk control and diversification tasks reasonably well. Fund characteristics such as size, expense ratio and portfolio turnover are all negatively correlated to performance. Simple regression analysis shows that all fund characteristics studied are reasonably good predictors of the performance measure. Among the fund characteristics studied, the average portfolio turnover has the highest explanatory power for the performance measure. This means that high performance funds were related to low expense ratio, low asset size (Net Asset Value) and low portfolio turnover. Hence, investment managers can improve performance by reducing expenses, managing smaller funds as well as avoiding active trading which only result in excessive expenses on brokerage.

The study also shows that the government backed funds are able to outperform the "buy and hold" strategy while the private sector funds do not show the ability to predict security prices and are unable to do better than the "buy and hold" strategy.[27]

Aw Mee Wah in his study on thirty-two Malaysian unit trusts over a thirteen-year period from 1984 to 1996 found that the funds in the sample could not outperform the market portfolio. By using KLSE Composite Index as a benchmark, only five out of thirty-two funds can beat the market. However, more funds exceed market portfolio after Emas index was used as a benchmark. This means that the fund performance is sensitive to the benchmark chosen to measure the normal performance. KLSE Emas Index which represents the overall market performance should be a better measurement since the fund managers invest in all kind of stocks whether blue chip, second or third liner stocks.

The result also shows that funds managed by different companies performed differently, with the best performing funds coming from the same management company. This means that different managements have different performance and investors may choose funds based on the capability of the fund managers. Besides that, the study also reveals that the funds in the sample are less risky than the market, thus offering security of capital for investors. The degree of diversification of the portfolio is under expectation and the performance is inconsistent over time. When the funds are grouped according to their objective, the study shows that growth fund earned the highest return followed by balance and income, but the risk profile shows that that the funds do not adhere very well to their objective. Hence, both the return and risk levels observed in the study suggest that the stated objective of the unit trust fund is not always dependable.

Since the performance of a unit trust is related to the ability of a fund manager to forecast security prices, the study shows that on average managers cannot forecast security prices and cannot beat the "buy and hold" strategy. The lackadaisical performance of unit trusts in Malaysia cannot be attributed to the lack of profitable investment opportunities in the economy as the economy has steady growth since 1988. A more relevant explanation could be the regulatory constraint imposed on the amount and the type of investment allowed. And since all unit trusts are subjected to the same regulation, the superior performance is probably due to their superior fund manager's performance. Besides that Aw Mee Wah also notes that the performance of a unit trust also depends on the timing of the launching. For example, a fund was launched during the market "super bear". Fortunately the market went up after three months. This caused the fund manager to perform superiority since they use "buy low and sell high" tactics. In fact, it is only the good luck of the fund manager. A good manager should be able to increase Net Asset value on the fund even though in the "bear" market.[28]

2.5 SUMMARY

In the beginning of this chapter we discussed about Malaysian unit trust industry including general concept of unit trust and types of unit trust fund which is currently traded in Malaysian market. In addition, the history of Malaysian unit trust is also revealed.

In the second part of the chapter we discussed the concept of *Mu'amalat* and the unit trusts from the Islamic perspective. As mentioned in early literatures written by Islamic scholars regarding *Mu'amalat*, there are several concepts that are associated with the modern unit trusts. However since there is no single concept that totally fits with the modern unit trusts and there are no similar products that existed in the past, the unit trust is categorized as *`Uqud Ghair al Musamma (a new contract that has yet to be determined).*

The third part of this chapter describes about the existing similarities and differences between these two types of unit trust. In view of the earlier existence of conventional unit trust as compared to the Islamic one we found that the implementation of the conventional unit trust has a great influence on the Islamic unit rust. However, there are still quite a number of differences between both systems especially in the philosophy and principles. Although the differences are not so obvious, it has a great impact on the acceptance of the funds among the investors particularly whether the fund is categorized as a permissible or otherwise. Beside that, the restriction imposed by Islamic law may cause an impact in performance of Islamic funds as compared to conventional funds.

The last part of this chapter quoted some of past studies, which is done by local and foreign researchers based on performance of unit trust all over the world in various places and period of time. However, there is no study which is concerning on Islamic unit trust. This is one of the uniqueness of this study compared to the others.

Endnote

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[1] Ab Mumin Ab. Ghani, (1999) " ***Sistem Kewangan Islam DI Malaysia***", Kuala Lumpur: Jabatan Kemajuan Islam Malaysia. p. 24

[2] This is based on *Hanbali* Scholar's opinion and strongly supported by *Ibn Taimiyyah* and his student *Ibn Qayyim*. They believe that everyone is free to make any contract and conditions and not limited only in determined contract such as *Mudarabah* and *Musyarakah*. Basically every contract signed is accepted and valid as long as there was no proof (*Nas*) from *Qu'ran, Sunnah, Qiyas* or *Ijma'* (scholar consensus) forbidding its. See the *Qur'anic* verse (5: 1), (17:34), (16:91) and (4:29). See Dr. Faizah Hj. Ismail (1995), "***Asas-Asas Mu'amalat Dalam Islam***", Kuala Lumpur: Dewan Bahasa dan Pustaka , p. 155-159

[3] Mohd Ali Baharum (Dr), "***Kaedah-Kaedah Syari'ah Dalam Mu'amalah***", Seminar of Islamic Business and Entrepreneurship at Maktab Kerjasama Malaysia, P.Jaya on 28-29 November 1987.

[4] Abdullah Alwi (1994), "***Sales and Contract In Early Islamic Commercial Law***", Pakistan: Islamic Research Institute, p.189

[5] Rohazlina bte Abdul Rased (1995), "***ASJ; Operasi dan Peranannya- Satu Penilaian Menurut Perspectif Islam***", B.Sh Project Paper, University Of Malaya, p. 29

[6] Zuhaily Wahbah al- (1985), "***al Fiqh al Islami Wa Adillatuh***" vol 4, Damsyik: Dar al-Fikr, p. 152-164

[7] Rohazlina bte Abdul Rased (1994), ***op.cit***, p.34

[8] The manager must be approved by the Securities Commission and must be a skilled investment professional. Investments in unit trusts are usually made by investors on the basis of a manager's track record as an effective manager of investments. The manager is responsible for day to day operations of the trust including:

i. Researching, selection, and ongoing management of investments (through the manager's Investment Committee)
ii. Preparing all notices and reports to be issued to unit holders
iii. Maintenance of accounts for the trust
iv. Buying back units from unit holders on request
v. Calculation of unit buy and sell prices based on the valuation of investments
vi. Convening of meetings of unit holders if and when required
vii. Issue of unit certificates/statements
viii. Insurance of real and personal property
ix. Maintenance of the register of unit holders
x. Calculation of income, and
xi. Calculation and payment of dividends (at the direction of the trustee).

Additionally, the manger will need to:

i. Set up the trust and obtain the legal and regulatory approvals
ii. Set up appropriate administrative and investment management systems
iii. Liaise with the trustee and keep the trustee informed as to the progress of the trust
iv. Achieve the investment objectives of the trust
v. Market the trust to investors
vi. Keep abreast of all developments covering the unit trust industry
vii. Be aware of the very onerous legal responsibilities of being a unit trust manager.

Please refer to Securities Institute Education Australia (1996), " ***An Overview Of Unit Trusts And The Role Of The Manager***" paper presented in Malaysian Unit Trust Administration Course, pp 6-7

[9] ***Ibid***. pp 12-13

[10] Master Prospectus (2000/01) prepared by RHB Unit Trust Management Berhad, p 14

[11] Securities Institute Education Australia (1996), ***op.cit***, p 15

[12] ***ibid***, p 15

[13] Baharin Salim (2000), "***A Comparative Analysis Of Conventional Banking System And Islamic Banking System In Malaysia In Relation To Loan Repayments***" MBA Project Paper, University of Malaya, pp 40-41

[14] Subject to any conditions laid down by the Securities Commission, the Funds may invest in the following investment:

i. Securities listed on KLSE or any other stock exchange approved by the Minister under the Securities Industry Act 1983 and any exempt stock exchange declared by the Minister under the Securities Industry Act 1983;
ii. Securities not listed for trading in a stock market of a stock exchange approved, or an exempt stock market declared by Minister under the Securities Industry Act 1983, but have been approved for such listing and offered directly to the fund by the issuer;
iii. Securities not listed for trading in a stock market of a stock exchange approved, or an exempt stock market declared by the Minister under the securities Act 1983, which are offered directly to the fund by the issuer and fulfills all the conditions set out in the guidelines;
iv. Foreign securities traded in or under the rules of a foreign market approved for investment by the funds by Bank Negara Malaysia and Securities Commission;
v. Investment in other collective schemes;
vi. Futures contracts traded in a futures market of an exchange company approved, or an exempt futures market declared, by the Minister under the Futures Industry Act 1993 must be for hedging purpose only;
vii. Participation in the lending of securities within the meaning of the Securities Commission's Guidelines of Securities Borrowing and Lending;
viii. Investment in an eligible money market (as defined in the Guidelines and as clarified in by any practice notes from time to time), including investments in an eligible market for short term papers such as Malaysian Government Securities, Treasury Bills, Negotiable Instruments of Deposit, Repurchase Agreements, Cagamas Mortgage Bonds, Bank Negara Bills;
ix. Investment in an eligible over-the-counter private debt securities market (as defined in Guidelines and as clarified in by any practice notes from time to time); and
x. Securities that are traded in or under the rules of an eligible market (as defined in Guidelines and as clarified by any practice notes from time to time) which fulfills all the conditions set out in the Guidelines.

The investments of the Funds may also consist of liquid assets which includes cash, deposits with licensed institutions and/or other institutions licensed or approved to accept deposits; any other instrument capable of being converted into cash within seven days as may be approved by the Trustee. And for Islamic Fund, the investments made by the fund must conform to *Syari'ah* Principles. Refer to ASM MARA Unit Trust Master Prospectus (2001/2002), prepared by ASM MARA Unit Trust Management Berhad, pp 30-31

[27] Chua Chin Pen (1985), " ***The Investment Performance of Unit Trust in Malaysia***", MBA project paper, University of Malaya

[28] Aw Mee Wah (1997), " ***Measuring Unit Trust Fund Performance Using Different Benchmarks***", MBA project paper, University of Malaya, pp74-76