CHAPTER 6

CONCLUSION

6.1 SUMMARY OF THE FINDINGS

The objective of this study is to make an exploratory assessment on the growth, development and performance of the Islamic unit trust sector in Malaysia over the past decade of its operation. Such evaluation and assessment is very important as the funds development and performance have important implication on the viability of the sector in particular and the Islamic capital market in Malaysia as a whole.

This research covers several aspects of the development and performance of the Islamic unit trust sector as a subset of the overall unit trust industry and in the context of the Islamic capital market in Malaysia. Among others, it covers;

1. The growth and development of the Islamic unit trust sector in Malaysia for the past decade based on several selected indicators;
2. The risk-adjusted performance of the Islamic unit trust funds measured by several indices, namely, Adjusted Sharpe Index, Treynor Index and Adjusted Jensen alpha Index;
3. Comparison of the performance of the Islamic unit trust funds with the market portfolio proxied by the RHB Islamic Index;
4. Comparison of performance of the individual Islamic fund;

5. Comparison of performance of the Islamic unit trust funds when grouped according to their objectives;
6. Comparison of systematic risk of the Islamic unit trust funds;
7. Adherence of risk-returns characteristics of the Islamic funds to the stated objectives;
8. Degree of risk diversification of the Islamic funds;
9. Consistency of performance of the Islamic unit trust funds over time; and
10. The influence of market movements on the performance returns of the Islamic funds.

In summary, the growth and the development of the sector were analysed using several indicators and compared with the overall unit trust industry. These include total number of approved funds, total size of fund approved, unit in circulation, number of accounts, and total net asset value. Generally, the Islamic unit trust sector showed a tremendous growth for the past decade with all indicators experiencing a strong continuous rising trend for almost the entire period. However, the sector had also faced with a decline in the asset of the funds in 1997 due to the Asian financial crisis and a slow down in the size of the sector in 1999. The superior growth on the part of the Islamic sector as compared to the industry had in turn increased the market share of the sector vis-à-vis the overall unit trust industry in term of all of the indicators over time and becoming more significant as an acceptable investment instrument.

In terms of the Islamic funds performance, for the nine and a half year period from January 1993 to June 2002, the results of this study show that as a whole, on average, the Islamic funds could not outperform the market portfolio represented by the RHB Islamic Index based on three risk-adjusted performance measures, namely the Adjusted Sharpe Index, Treynor Index and Adjusted Jensen's Alpha. However, individually, five of the thirteen funds under study managed to outperform the market portfolio when based on the Adjusted Sharpe Index. Again, all of the Islamic funds as well as the market portfolio returns are substantially lower than the risk free returns represented by the rates of the 3-month Treasury bills. This is consistent with the result of past studies on the Islamic unit trust as well as for the conventional ones. This finding suggests that unit trust as a whole had performed below expectations and is still unable to achieve its objective in achieving excess returns with extra risk. Nevertheless, our results also show that the Islamic unit trust funds as a whole, on average, have reasonably low systematic risk as compared to the market and can be assumed to be less risky than the market portfolio or conservatively managed, hence they offer security of capital for investors.

When the individual Islamic funds are ranked using the risk-adjusted performance measures, it is found that AMTI, BHLBDAI and PDA were the consistent top performers in term of all the indices while ASMDAA and ASBITP were consistently at bottom ranks in all performance measures.

It is also found that the risk-returns characteristics of the Islamic unit trust funds are significantly inconsistent with their respective stated objectives. For instance, the supposedly least aggressive income fund obtained the highest return and recorded the highest systematic risk compared to other groups. The more aggressive growth funds did not put up a higher return in all the performance measures and its systematic risk is around average relative to all the five types of Islamic funds studied.

It is also discovered that the Islamic portfolios were poorly diversified and its level had deteriorated as compared to the result of a past study by Kemal Rizadi (1999). A further analysis on this finding shows that the decline in the degree of risk diversification was largely due to the declining trend of R2 values towards the end of the period under study with the observations during 2000/2001 being the outliers where most of the funds have significantly low values of R^2 with insignificant beta coefficient. This implies that during the particular year, market movement did not have influence in the performance returns of the Islamic funds. This phenomenon can be an interesting subject matter for future research to determine what are the other factors that influence the returns of the Islamic funds during the period. The result also shows that the degree of risk diversification of the Islamic unit trust funds vary substantially among different categories of funds.

It is also shown in the study that the performance of the Islamic unit trusts funds is not consistent over time. Hence, historical performance records cannot be an indicator of future performance.

6.2 IMPLICATIONS

The major implications raised by this research are:

1. The investors should be wary of the statement made by the management companies. Without being based on a more objective measure, or after incorporating the associated risk, some fund managers claim superior performance over the performance of the market portfolio.

2. Different management companies have different performance and investors may choose funds based on who the fund managers are.
3. Since the risk and return characteristics of the Islamic funds were not congruent to the stated objective, the investors should not just rely on the information and the stated objectives from the Islamic funds prospectus when choosing a fund for investment. Nonetheless, Investors may look into the composition of the funds investment and determine whether such holdings of asset suit their needs.
4. Since the degree of risk diversification of the Islamic funds were generally poor, investing in Islamic unit trusts is not the best way to diversify the risk of investment although it is less risky than investing directly in the stock market.
5. Since the Islamic fund managers were not able to perform consistently over time, the investors should not just rely on the historical performance records as an absolute indicator in making their investment decision for the next period.

6.3 CHALLENGES AND PROSPECTS

6.3.1 Overall Unit Trust Industry

Since unit trust fund comprises the largest portion of the collective investment scheme, it has an important role in promoting the investment management sector in the domestic capital market. The emphasis is based on the fact that healthy development of the unit trust industry will bring about greater institutionalisation of the domestic market and in turn contribute to efficiency and stability as well as the depth and breadth of the Malaysian securities market. A well developed unit trust industry will provide adequate liquidity in the capital market, reduce the impact of sudden reversals of foreign capital flows, and provide efficient way in financing corporate growth and expansion, which will eventually foster economic growth.

The plunge in the KLSE, with a loss of around RM600 billion of wealth in stock prices, due to the sudden reversal of foreign funds from the domestic capital market had taught a costly lesson to the country. Hence, the domestic capital market must reduce its dependency on foreign capital inflows by increasing the institutionalization of funds in the domestic capital market. It is for that reason that the unit trust industry plays an important role as an intermediary for collective investment and institutionalising surplus funds in the market.

However, despite tremendous efforts by the government to promote unit trust through many of its sponsored funds and the encouraging response of the public on unit trust investment be it the publicly managed funds or private management companies, and whether in the Islamic funds or the conventional ones, the industry is still at its infancy. As shown in Table 6.1 as at 30 June 2002, the unit trust fund only constitutes about 10.64% of KLSE capitalization. Subsequently, the Islamic unit trust funds only represent a marginal portion of the total size of the overall unit trust industry and a miniscule per cent of the KLSE market capitalization.

These figures are significantly smaller than the figures obtained for developed countries such as the United States, United Kingdom, and Australia where total net asset value of the unit trust or mutual fund industry constitutes at about 40% of market capitalization.

One of the reasons of the Malaysian phenomenon perhaps is that the returns provided by Malaysian unit trusts is only a little above the risk-free rates and bank's fixed deposit rates[4]. Thus it provides little attraction for the Malaysian investors. Furthermore, a lot of shares in the KLSE can be considered penny stocks where small capital investors are still able to invest directly to reap quick profit during the bull-run. On top of that, many Malaysians do not really understand the concept of unit trusts. In reality, unit trusts should be viewed as medium and long term investments which offer long term capital growth with comparatively low risk. However, many investors still think that investing in unit trusts is like investing directly in the stock market where one stands a chance of gaining a quick profit. As a result, there is a high tendency of investment redemption by those unit holders who did not see any quick returns from their investments.

In addition, the bitter experience of the plunge in the stock market which ripped almost 45% of the overall unit holders' wealth in the unit trust industry has been traumatic for many investors. The sharp decline in the net asset value of the funds portfolio with the sudden fall in unit prices had in turn caused significant capital losses to unit holders.

However, the optimism in the industry is expected to hold firm. The potential for growth in the Malaysian unit trust market seems considerable. While unit trusts

[4] Such finding was obtained by Ch'ng (1997). On the other hand, the findings of Kemal Rizadi (1999), Suhaili (2001) as well as in this study found that the returns of Islamic funds in fact lower than that of the risk free rates.

have existed as an investment tool in Malaysia for 40 years or so, the industry is far from reaching its critical mass. The industry is still young with vast amounts of room for growth in funds under management which is expected to occur over the next five to ten years.

Table 6.1: Selected Indicators of the Industry's Growth Prospect

Indicators	Sector	1996	1997	1998	1999	2000	2001	2002*
Growth in Total NAV	Islamic	40.96	-42.74	25.37	65.48	20.86	44.05	18.60
	Industry	35.87	-44.01	14.30	11.05	0.67	9.33	13.67
Total NAV to Market Capitalization	Islamic	0.15	0.18	0.22	0.25	0.38	0.52	0.57
	Industry	7.40	8.93	10.34	7.78	9.74	10.18	10.64
Growth in KLSE market capitalization (%)		43.20	-53.60	-0.36	47.50	-19.90	4.60	8.70

Note: * As at 30 June 2002

While it appears that unit trust capitalization can exceed 40% in some countries, such as in the United States, it does not necessarily mean that the same extent of capitalization will be reached in Malaysia. This is due to the fact that the country has a comprehensive retirement accumulation plan known as the Employees' Provident Fund (EPF) which accounts for 22% of total Malaysian salaries and more than half the national savings rate. Countries like the US and UK do not have such schemes, so employees in these countries have to invest in unit trusts and mutual funds to provide for their retirement needs.

There is however, considerable growth expected as the extent of total NAV to market capitalization moves from its base of around 8-10% of stock market capitalization. If the 20% level was to be reached, this would translate into a ringgit increase of around RM 50 to RM 60 billion. The increasing percentage of the total NAV of unit trust industry to market capitalisation from 7.4% in 1996 to 10.64% in 2002 is not necessarily due to a higher growth rate experience by the industry. It is likely that the sharp fall of KLSE market capitalisation had propped up the ratio. This represents even a greater opportunity for unit trusts to increase and sustain their growth patterns in the coming years.

Hence, as the stock market gains firmer footing and if it manages to gain back its pre-crisis level, the expected sum of increase would amount to RM104 billion to almost RM160 billion under management. It is the expectations of growth of this magnitude that provides the industry greater degree of optimism for further expansion.

In addition, a closer look at the above figures indicates that the unit trust funds manage to keep its portfolio net worth fluctuations below that experienced by the market. While stock market capitalisation plunged more than 50%, unit trust funds recorded a decline in the vicinity of 40%. On top of that, the total net worth of the industry still registers a positive growth despite the decline in the stock market capitalisation in 1998 and 2000. This observation again is consistent with the above findings of lower beta values of the Islamic unit trust funds which suggest that investment in unit trust bears lower risk than a direct investment in the stock market.

6.3.2 Development of Islamic Instruments

As the growth prospect of the industry is foreseeable, the development of Malaysia's Islamic capital market and in particular the Islamic unit trust schemes must be made in a comprehensive and structured manner. Developmental agendas must be continued with full support and commitment from all parties. Efforts to introduce a variety of Islamic investment opportunities to meet the needs of investors who seek a reasonable return for a level of risk which they are comfortable with, must be intensified. At the same time, market intermediaries should be encouraged to offer a wide array of Islamic capital market services to provide depth and breadth in the system. In that sense, fund managers have a better chance of bringing in new clients as well as keeping existing clients if they have a full range of Islamic investment alternatives to offer.

In order to do so, dialogues and discussions between *syariah* scholars and industry and market practitioners must be encouraged. The role of Islamic jurists who have much to offer on the subject of *fiqh muamalat*, and market practitioners who have much to contribute as to the needs of a modern market place in the development of a well-functioning Islamic capital market is critical.

In addition, efforts to increase the universe of Islamic financial instruments must be continued. While the acceptance of conventional instruments can be handy, we will not do justice to the richness of Islamic *fiqh* if we do not use it to innovate new instruments which are acceptable to Islam. Hence, the first approach of identifying and isolating conventional instruments that are acceptable to Islam must be supported by efforts to innovate new and original Islamic financial instruments based on the various Islamic concepts. Developing an original *muamalat* instrument requires , however, a longer and more demanding process. It requires a detailed understanding of the various types of Islamic financial contracts and a thorough appreciation of the contemporary needs of the issuers, investors and intermediaries in the market. It also requires the ability to structure products which would not only satisfy the *syariah* but consistent with the commercial legal system of the country. The ability of *fiqh* scholars and industry experts to work together to structure such products is clearly manifested by the use of various *muamalat* concepts such as *bai'* *al-dayn, bai' al-ina, istisna', murabahah, bai' bithaman ajil and ijarah* in structuring Islamic debt papers. The concept of a benevolent loan or *qardhul-hasan* has also been used in structuring government investment certificates.

6.3.3 Increasing Market Demand

Efforts to develop new Islamic investment products must in turn be supported by strong and increasing demand by investors to ensure its continued growth and development. In order to further increase the acceptability and the critical mass of the Islamic unit trust schemes, management companies should target investors at-large rather than a particular segment of the market. This is to attract more retail investors who are not highly sensitive to market fluctuations to participate in the schemes. Funds that were designed to attract the high net-worth investors, who are likely highly sensitive to market movements, would have not been able to maintain these investors especially in the adverse phases of the market. In this context, lesson should be taken from the Islamic banking services when the sector experienced a stagnation of total deposits in 1990 and 1991 in the event of a rising interest rates in the market. This is an indication that high net-worth investors, institutional or corporate sector is highly sensitive and elastic to market changes. Furthermore a high dependency on this segment will result in a greater exposure to the liquidity problem. Islamic management companies must therefore, from time to time, improve their distribution channels to provide greater accessibility to their financial services. Besides that, they should also charge low up-front sales load, keep annual management fees at or around the industry average, and ensure minimum investment thresholds low enough to attract the retail investor. In this sense, besides the benefits of low rates of redemption, the Islamic unit trust sector can also improve the utilisation ratio and increase the size of funds under management.

In the years to come, the unit trust industry is expected to undergo significant changes in the way and manner in which funds are distributed. This will result in increased professionalism and better marketing of the products, which in turn will result in larger volumes of funds under management. This prompted the need for serious efforts to be taken to ensure the existence of a sufficient pool of intermediaries well versed with the various aspects of an Islamic capital market.

6.3.4 Investor Awareness

A more fundamental issue would be with respect to the client education. Educational programmes should be conducted to expose both Muslim and non-Muslim investors to the workings of a capital market in accordance with the *syariah*, especially the need to be clear on the product differentiation that is between Islamic and conventional funds. Novice investors see minor differences between the two. The need to invest in *syariah* compliant funds has not clearly been addressed as investors do not see the differences between investing in a conventional unit trust fund and a *syariah* compliance unit trust fund. After all, the equities in the portfolio can sometimes be nearly identical. Thus, Muslim investors must be exposed and educated with the mechanics of stock screening process and the obligation to comply with the principles of *syariah* in all aspects of their lives. As for the non Muslim investors, efforts should be made to overcome the typical misconceptions on the concept of *syariah*. The *syariah* principles in Islam only prohibit certain business activities that are considered unlawful such as gambling, production of liquor or non-

halal food, interest-based transactions, etc. Apart from that, it does not restrict business activities and transaction nor does it limit the available choices and variety of investments. As a matter of fact, Islamic funds are open to all Malaysians irrespective of race or religious belief.

6.3.5 The Prospects

A successful and mature Islamic banking system which is supported by an equally successful and vibrant Islamic capital market will provide Malaysia with a niche that will greatly contribute towards the attainment of our objective of making Kuala Lumpur a regional financial centre.

Much remains to be done in our effort to create Islamic capital market instruments, intermediaries and institutions and to educate investors as to the benefits of an Islamic capital market framework. However, some firm foundations have been laid, particularly in the equity market, money market, unit trust, government and private debt securities as well as in other segment of the financial system especially in the Islamic banking services. With all of these in hand, I would share the optimism of the formation of a well functioning Islamic capital market in Malaysia in the near future.

It is worthwhile to acknowledge here several positive contributing factors for the smooth development of the Islamic capital market as a whole and in particular the Islamic unit trust schemes in Malaysia;

- Strong government backing for developmental efforts
- Relatively well developed domestic Islamic financial sector

- Increased investor and issuer awareness and sophistication
- Our strength in research capabilities

Finally, the success of a financial market, be it Islamic or otherwise, will largely depend on the confidence of market participants in the system and process, a variety of quality products, and a reason for investors and issuers to use these products. Hence, continuous efforts must be taken to ensure these elements exist and flourish in the context of the Islamic unit trust sector and the Islamic capital market as a whole. It is hoped that the strong and continuous commitment towards the developmental agenda from all parties, including investors, issuers, intermediaries, regulators, scholars and researchers will result in the formation of a truly Islamic capital market, one where capital is allocated and risks are managed according to the principles of Islam.