

Shari'ah-Compliant Investing



GRAYSWAN
INVESTMENTS

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General Islamic investment principles are¹:

1. Investments must comply with Shari'ah principles;
2. Investments must comply with specific financial ratio filters; and
3. Investment managers must conduct a purification process on impermissible income.

Shari'ah investing principles exclude businesses whose primary activities involve any of the following practices¹:

1. Conventional banks;
2. Insurance companies;
3. Financial services (interest based instruments);
4. Entertainment (hotels, casinos, cinemas, music etc.); and
5. Companies manufacturing, selling or offering alcohol, pork, nightclub activities, prostitution, pornography, gambling, short term sales, arms, weapons and tobacco.

Companies involved in these business practices are prohibited and discarded from any investment purposes. All remaining companies need to undergo

further evaluations according to a series of Shari'ah approved financial ratio filters.

These specific financial ratio filters are²:

- Debt \leq 33% of total assets;
- Cash and Interest bearing items \leq 33% of total assets;
- Accounts receivable and cash \leq 50% of total assets; and
- Total interest and non-compliant activities income \leq 5% of total revenue.

Internal Controls

Investment managers must satisfy the requirements of a Shari'ah Supervisory Board (SSB). The SSB is appointed by the investment manager, but is an independent body of specialised jurists in *fiqh almua'malat* or Islamic jurisprudence. If a fund is declared to be Shari'ah-compliant strict controls and monitoring of the fund continue to apply², e.g.

- Monthly reports to the SSB;
- Monthly internal audit;
- External audits twice per annum;
- Monthly purification and cleansing;
- Any addition to the existing portfolio can only be made with approval of the SSB; and
- Queries or irregularities are immediately notified to the SSB.

Key Role Players in South Africa

In the equity mandate universe of South Africa there are seven investment managers that manage Shari'ah-compliant equity funds which will be of interest to pension/retirement funds.

¹ *Element IM Shari'ah Brochure*. (2009). Available from: <http://www.elementim.co.za/shariah>

² *FTSE Shari'ah Global Equity FactSheet*. Available from: <http://www.ftse.com>

As at end of August 2011, these funds have track records between 1 year and 19 years. The assets under management (AUM) ranges from R30 million to R18 billion.

The Shari'ah balanced mandate universe consists of five investment managers. These funds have much shorter track records, with inception dates mainly from 2009 onwards. Since these funds are all relatively new, the AUM amounts are noticeably smaller, ranging from R5 million to R830 million.

Our research shows that the performance of Shari'ah funds are on average lower than the performance of equivalent risk profiled non-Shari'ah funds and also lower than standard market related benchmarks. For example, the SWIX (Shareholder Weighted Index) outperforms Shari'ah equity funds on average.

When comparing Shari'ah balanced funds to a benchmark such as CPI+4%, we see similar results.

Investors should rather use Shari'ah adjusted benchmarks for these types of funds. The FTSE/JSE designed the Shari'ah All Share Index to reflect the Shari'ah compliant companies from the FTSE/JSE Africa All Share Index as screened by Yasaar from the FTSE/JSE Africa All Share Index. There is also a FTSE/JSE Shari'ah Top 40 index. This index is selected from the FTSE/JSE Top 40 index but it includes only companies that meet the screening requirement. The index will not always contain 40 constituents³. Our research outlines those investment managers that have been successful relative to these more relevant benchmarks.

³ *History of the FTSE JSE Africa Index Series*. Available from: <http://www.jse.co.za>

⁴ Blees, W. (Apr 2011) *Shari'ah-compliant products go from strength to strength*. Available from: <http://www.risk.net>

To Invest or Not To Invest

Excessive risk-taking is deemed to be un-Islamic and the question of morality ranks highly when determining whether a particular transaction is approved. As a result, while Shari'ah-compliant funds also suffer from equity market downturns, the impact of losses is cushioned by the more conservative nature of these funds⁴.

However, Shari'ah funds can be more expensive to develop and administer than equivalent mainstream funds due to the need for greater screening and verification of compliance to such methodologies. Costs are raised by the need to appoint and compensate Shari'ah Boards, the necessity of asset screening and a lack of scale in funds, while valuation is potentially clouded by a lack of liquidity in some instruments (specifically if they are not listed).

Nonetheless, it will be interesting to see how the Shari'ah-compliant funds industry performs over the next few years. Perhaps the single most important factor behind potential future growth lies in the simple fact that Muslims represent about a quarter of the Oworld's population.

If you, as an investor, wish to peruse our detailed Shari'ah research document please contact Duncan Theron at duncan@grayswan.co.za or alternatively, Neelke Stadler at neelke@grayswan.co.za or on 012 852 9092.



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