

# Shariah Investing: Beating the Credit Crunch

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Shariah Finance continues to gather pace with a recent report estimating that assets now exceed \$1.7 trillion and are projected to reach \$2.7 trillion by 2010. However, this is not without its challenges and debates. Amongst other challenges that have been highlighted, there is continued debate on the need for a central Shariah Council to introduce standardisation across the industry. It is important that we balance this need against that for continued product innovation and the ability to introduce new solutions to the market in a timely manner. The industry doesn't need to be constrained but governed.

The growth to date has been focused on the development of institutional and corporate structures, but there is increased discussion on the need to further develop Shariah compliant investing. To date Shariah compliant investing has been perceived by many investors as underperforming the conventional investment market. Infact a recent report<sup>1</sup> shows that Islamic investors continue to choose conventional investment solutions over Shariah compliant structures, indicating that they may be putting their religious beliefs second to investment performance. However recent market volatility has shown contradictory results, and has highlighted the strengths of Shariah investments.

Conventional equity funds have been hit hard by the sub-prime fiasco and continue to suffer the ongoing effects of the credit crunch, meanwhile 2007 was a strong year for Shariah compliant equities with Islamic Indices outperforming their conventional counterparts and continuing to do so into 2008. Figure 1 clearly highlights the strength of Shariah equity funds from early on in the 2007 Subprime crisis. Shariah performance tracked conventional equity markets in the early days, and at the "official start of the crisis" in February 2007, The Dow Jones Islamic Developed World Index began its move away from the declining MSCI World Index and has shown consistent outperformance to date.

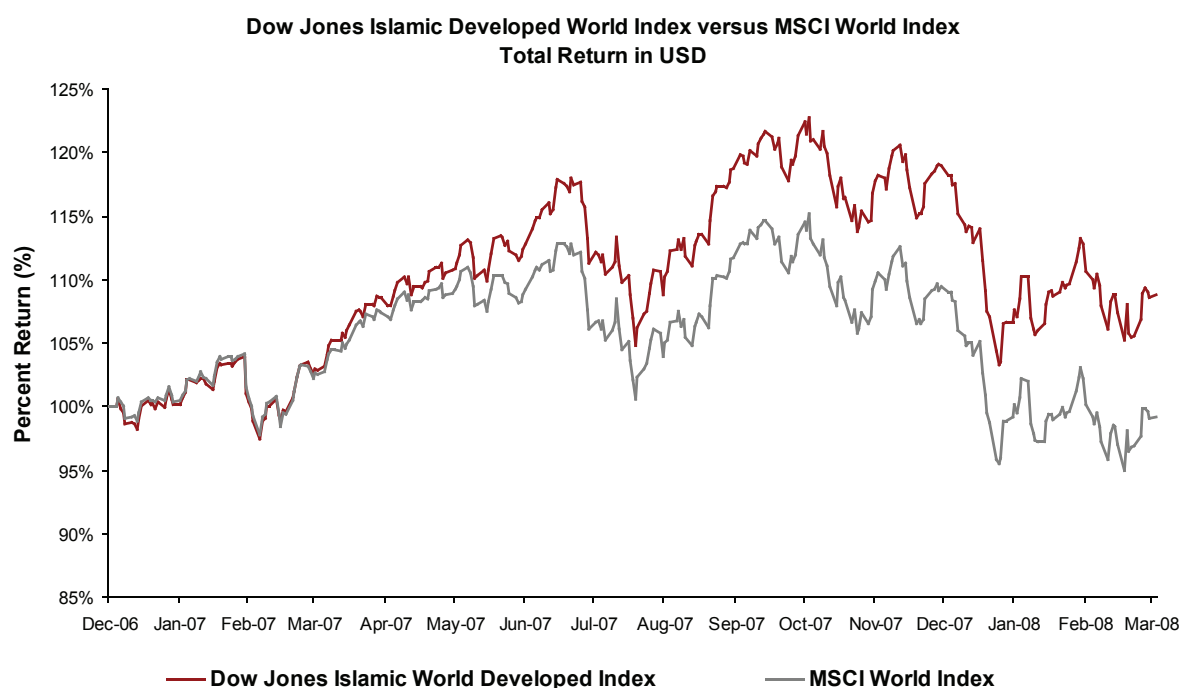


Figure 1 : Source - Factset, Dow Jones Islamic Indexes

1. Ernst & Young 2008 World Islamic Finance Report

Shariah compliant structures have many screens and requirements that should be recognised as contributing to this outperformance. The oft-quoted aversion to the financial services sector is only one of those. In addition, the Shariah filters resulted in an overweight of cyclical sectors such as IT, Health Care, and Energy and underweight more defensive stocks such as Consumer Staples and Utilities. These sector allocations resulted in further outperformance relative to the conventional counterpart. This trend has been consistent since December 2006.

Figure 2 highlights that the common view that the industry and financial ratio filters for Shariah compliance limit the universe of investible stocks, potentially impacting performance in a negative manner. However, Shariah investors appear to have benefited from the characteristic exclusions and the favoring of sectors that have proved resilient in the current economic climate.

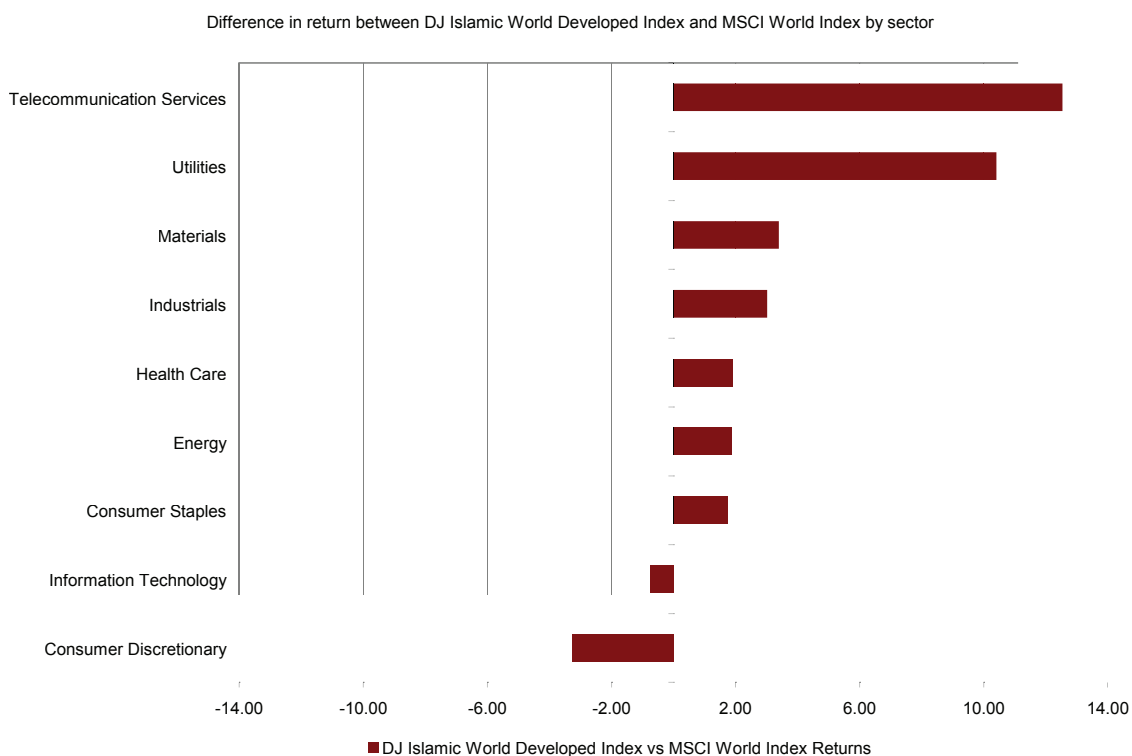


Figure 2 : Source - Factset, Dow Jones Islamic Indexes

Of greater significance has been the due diligence procedures associated with stock / company selections that are mandated under Shariah principles; the exclusion of highly leveraged companies became a key factor through this period.

Highly leveraged companies suffered over the recent period, and stocks showing lowest level of debts on their balance sheet outperformed by almost 35% (see Figure 3). Quantitative ratio filters mean the Shariah complaint universe is generally made up of companies with strong cash flows, robust returns on equity, and a solid balance sheet. These characteristics have clearly been rewarded in a period of credit and liquidity constraints whilst the volatility in stock prices of highly leveraged firms significantly increased through the recent market downturn.

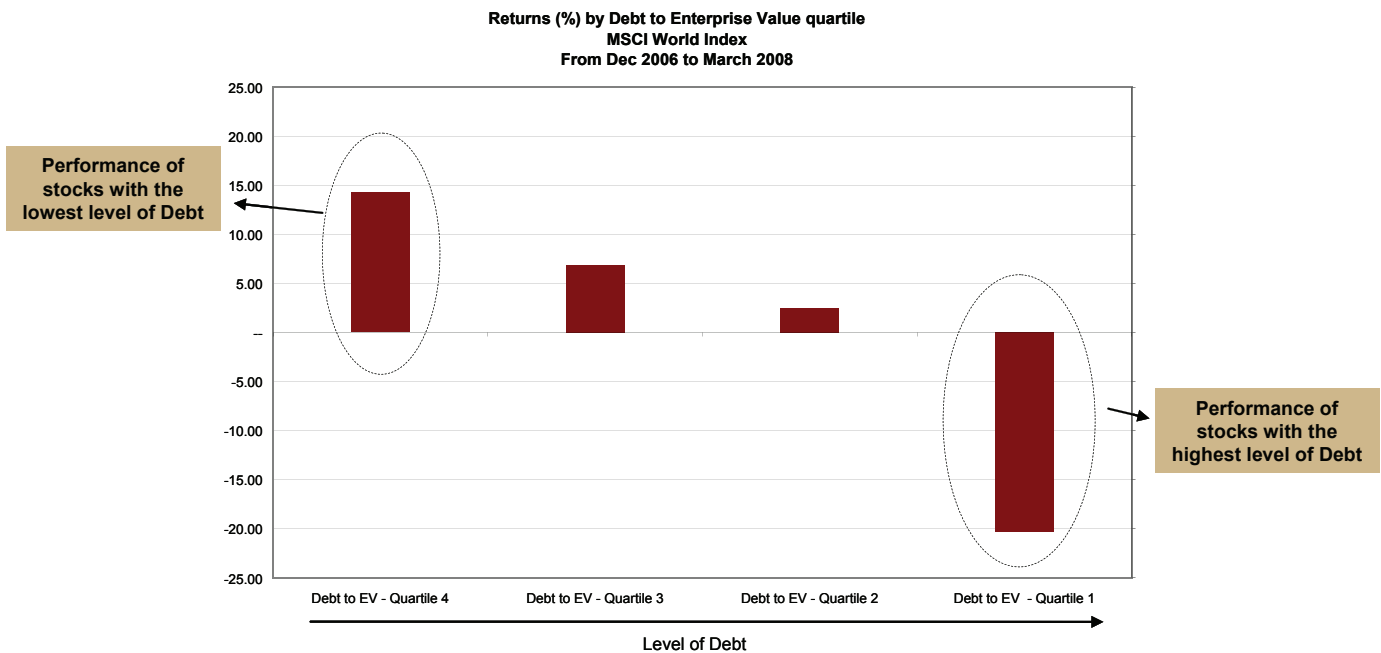


Figure 3 : Source - Factset, Dow Jones Islamic Indexes

The need for stringent research to ensure compliance both pre and post the purchase of any stock is another key benefit of Shariah investing. In considering total debt to market capitalization off-balance sheet debt has to be considered as well and research has to be extensive. Avoiding excessive stock trading and adopting a buy and hold strategy also tends to fare well for Islamic funds as constant trading can tend to drag down a portfolios overall performance.

In conclusion, we believe there is a strong argument to support the notion that Shariah investing is not the 'poorer cousin' of its conventional counterpart, but is a viable alternative approach. Whilst the behavior of Shariah funds at the individual fund level is no different to Conventional counterparts in that some will outperform and others will underperform, recently Islamic indices have highlighted that their low-debt, non-financial, social-ethical approaches work in market downturns. This trend was not unique to the MSCI World vs DJ Islamic, but can be seen across the US, Europe and the Asia Pacific markets.

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