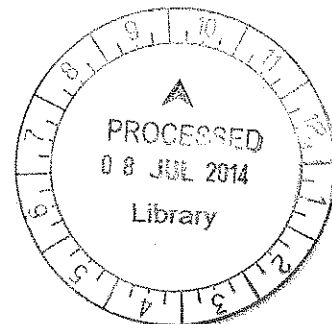# INTI INTERNATIONAL UNIVERSITY

MASTER OF BUSINESS ADMINISTRATION

PERFORMANCE MEASUREMENT OF SYARIAH COMPLAINT STOCKS AND CONVENTIONAL STOCKS IN KUALA LUMPUR STOCK EXCAHNGE

Author	:	Ali Salman
Student No	:	I13002289
Supervisor	:	Mr Salaar Farooq
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Abstract

Analyzing the characteristics and performance of Islamic stocks with conventional stocks

A critical Review of Malaysian Case

This research provides an acute review on the performance and characteristics of Syariah compliant stocks and conventional stocks in Malaysia with main objectives of identifying and comparing the risk and return of both type of stocks. Performance is measured by using independent samples T-tests, Mann Whitney test and regression analysis to evaluate the relationship between the Syariah and conventional stocks returns of companies with their financial ratios. Using average weekly prices, the result shows that there is no statistical significant difference between the mean return and risk between both types of stocks. In addition, conventional stocks shows higher return with higher risk than Syariah complaint stocks. The regression shows that Earning per share and return on equity has significant relationship to stocks return of Syariah and conventional.

Key words: Financial Ratios, Syariah stock return, Conventional Stock return, Kuala Lumpur stock Exchange.

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Along with it, I would like to dedicate my thesis to my lovely parents and siblings without their support and prayers it would not have been possible to achieve my dreams.

At last I dedicate this work to my friends who helped me in releasing stress of work and converting the stress in to positive energy to finish my work.

Declaration

The work presented in this thesis is the fruition of my own work and effort, never has this work been submitted for any other award but for the partial fulfillment of MBA studies at INTI International University, Malaysia.

Any information used within this study from other sources has acknowledged to their respective authors.

Name   : **Ali Salman**

Signature   :

Date   : **28**th **April, 2014**

List of Abbreviation

DER   Debt to Equity Ratio

EPS   Earnings per Share

PER   Price to Earnings Ratio

NPM   Net profit Margin

ROE   Return on Equity

CAPM   Capital Assets Pricing Model

APT   Arbitrage pricing theory

EMH   Efficient Market Hypothesis

FY   Fiscal Year

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Chapter 1

The Introduction

1.0   Introduction

The motivation behind this study is the inspirational growth in the Islamic financial industry. The assets value of Islamic portfolio has increased immensely over last two decades. Several explanations have been given by the researchers behind increase in demand for Islamic financial securities relative to conventional financial securities. Primarily, the potential ability of stocks to generate abnormal returns relative to conventional stocks. The second reason given is the change in investors' attitude and preference towards ethically oriented investment based on religious, personal and social values. Despite considerable success in the development of Islamic funds to cater the needs of the public still Islamic funds have continuous more to offer to the investors (Rahime, 2010).

1.1   Research Background

The idea for investment comes to people's mind when they have enough savings out of their disposable income. Investors tend to invest with the intention to earn higher returns. Recently, people are more concerned about socially responsible investments based on ethical, religious and social factors. A general opinion about ethical stocks exits among investors that they yield lower return as compared to market portfolio returns due to stringent screening process. Common investors suggested that ethical portfolio of stocks lacks sufficient diversification than market portfolio of stocks (Rad, Bauer & Otten, 2006).

The demand for Islamic financial securities all around the world was estimated to be USD 1.6 trillion at the end of 2012. This shows a growth of 20.4 % each year since 2011 according to latest report of Islamic financial industry, Malaysia (Islamicfinanceinfo.com.my, 2014). There are three main reasons for this significant increase in the demand for Syariah financial assets.

First, the robust demand from Muslim communities around the world for Islamic product and services such as sukuk (bonds), takaful (insurance) and management services. In Malaysia Islamic based investments have received overwhelmingly acceptance from general investors. Secondly, dramatic change in the trend or behavior from the wealthy Muslim oil rich nations towards the Syariah compliant stocks for investment. Thirdly, after global financial crisis and continuous instability in the conventional financial system, non-Muslim investors are also starting showing their confidence on the Islamic financial system.

Currently, there are total 653 Syariah approved securities in Kuala Lumpur Stock Exchange also known as Bursa Malaysia Berhad, representing as 71% of total listed companies in the Kuala Lumpur stock exchange , with approximate capitalized market value of 390 billion Malaysian Ringgit. This amount clearly indicates that Islamic based investments have increased great significance and potential in Malaysian stock market. (Sc.com.my, 2014)

Ethically orientated funds (Islamic funds) are competing with conventional stocks to attract investors for subscription fee to be listed as ethically stock in the stock market. The viability of ethical stocks are evaluated in terms of making positive returns for the investor. Unfortunately, past result shows that ethical stocks compromise in terms of higher returns and profits as compares to conventional stocks due to obliging to ethical principles; hence, result in underperformance of Syariah funds compared with conventional funds. The underperformance of ethical stocks are explained by cost-of- discipleship hypothesis which suggest that ethical screening standards withdraw the flexibility of assets and choice of funds.(Mueller,1994;Schwab 1996). The performance of Islamic funds looks unclear and consists of ambiguities based on past researches which sometimes claim that conventional funds returns are higher than Islamic funds. For instance, Yakob (2002) and Yaacob (2002), Abdullah et al (2007) and Shah Zaidi (2004) affirmed that Islamic funds outperformed then conventional funds and this is also supported by Nik Muhammad and Mokhter (2008). According to Abdullah et.al (2007) Islamic stocks better perform than conventional stocks in bear market period and underperform in bull period .The major reasons for the inverse relationship results in both market periods are differences in the time period of market research and dynamic market conditions.

Omer and Hussain (2005), Shah Zaidi (2004) Yaacob (2002) and Yakob (2002) used traditional portfolio valuation models of Sharpe Index, Jensen-alpha index and Treynor index to analyze the

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data of Islamic funds. These portfolio performance measurements have their basis on the economic theory of utility maximization of an economic agent. Bernoulli (1738) insisted that value of an asset is determined by the level utility yield to an agent rather than its price. A magnificent work had been done on asset pricing and level of risk by Sharpe (1964) and Debreu (1954). Markowitz (1952) gave a new concept of modern portfolio theory. His idea clearly demonstrated that variability in the return of individual security contributes in the overall risk of the portfolio. The most efficient way to reduce overall risk of the portfolio is by avoiding securities in a portfolio with high positive co-variance amongst stocks. An optimal portfolio which offers maximum return for minimum risk. These modern portfolio theories are based on three assumptions: rational investors, arbitrage opportunities for investors and markets efficiency (Mussavian and Dimson 1999).

Ethically motivated investors have more objectives beyond those of profit maximization. Therefore, a pious Muslim investor does not achieve maximum utility not merely through profit maximization but by subjecting itself to religious obligations and principles. It does not mean that Muslim investor are less profit conscious but in fact Islam does not restrict its followers from wealth accumulation. Perhaps, they emphasizes on accumulation of assets and wealth through legitimate means. Along with it, Islam classifies the expected utility of Muslim investor in different from conventional investor. Muslim investor expected utility is a function of maximization of wealth with religious beliefs and gains whereas conventional investor utility is maximize through only profit maximization.

There is a concern which prevails after all this discussion that Syariah limitations restrict the maximization of return on Islamic funds by not allowing the non-halal stocks in the portfolio thus the portfolio is considered as less competitive in return than those of conventional funds. Moreover, this type of restriction expose Islamic funds to a problem of moral hazard since managers can use it for their ineffectiveness as the reason for poor performance of Islamic funds (Wilson, 1997). According to modern portfolio theory, ethically or religiously based investment is not acceptable because it limits the choice of assets for the investor which ultimately results in failure to achieve optimal mean- variance portfolio (Kurtz, 2005). According to modern portfolio theory, an investor is rational; therefore, he or she is only concerned with the risk and return relationship in selecting the securities.

In conclusion, this study is particularly motivated by the marvelous growth in the Islamic finance industry. Despite the fact showed in past research, Syariah funds generally yield lower returns as compare to conventional funds. It is apparent from the attractiveness of Islamic funds that returns are not only driver but there are also various religious and social objectives for choosing the investment. Consequently, the old portfolio valuation model based on risk- return analysis may not be appropriate method to measure the performance of Islamic or ethical funds objectively since they are biased. Gregory (1997) argued that the underperformance of ethical stocks by using Jensen-alpha stock valuation technique gives the ethical portfolio higher concentration of investment in small capital stocks. Therefore, further research needs to be done to find new improved method of assessing the ethical funds.

The difference between Syariah compliant stocks from the conventional stocks are based on the market characteristics or set of Islamic principles of Mu'amalat. Mu'amalat means financial rights and obligation between the individuals based on Islamic principles (Majd Bakir, 2013).

A cynical perception exist that Syariah complaint stocks generally underperform as compared to conventional stocks (McGowan & Junaina, 2010). This idea is based on the fact that before a stock registered as Syariah compliant stock, it has to go through very stringent screening process in Malaysia, therefore, it is responsibility of the Syariah advisory council to ensure that a company is not involved in any unethical Islamic activities For example, Riba (Interest), Maisir (Gambling), Gharar (speculation) and gaming; Maysir (Uncertainty)

Other Islamic concepts of finance are like Ijarah (Leasing), Mudharabah (Profit sharing) and Musharakah (partnership) and supporting the economy in terms of real assets. Companies should not indulge in the manufacturing of non halal food or products such as liquor or tobacco which are Haram according Islamic religion. Islamic finance emphasizes on a transaction based on real trade or activity to promote accountability and risk mitigation.

Other than this, SAC (Syariah Advisory Council) takes into consideration sources of income in total revenue of a company such as a stock will be classified as non- Syariah compliant if income generated from prohibited activities like interest, gambling and pork or liquor exceeds 5% of total income. Second, a 10 % benchmark is set for "umum balwa" activities which are difficult to avoid and affects the health of human being for example tobacco sales. 20% benchmark is used

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for rental income which generates from premises that involved in gambling or sale of liquor (Mifc.com, 2014).

In order to satisfy the growing demand of investors from both local and international markets, Kuala Lumpur Syariah index was launched on 17 April 1999 by Kuala Lumpur stock exchange. In the beginning 279 companies registered as Syariah complaint stocks but with the time period this number has reached to 801 out of 910 total listed stocks consists Syariah and conventional stocks.

1.2   Problem Definition

According to previous studies done by various researchers like Ahmed and Mustafa (2002), Zamri & Haskind (2002), and Mamat (2002) calculated the risk and return between Syariah and conventional indices were calculated and the results are generally mixed but inclusively they found that Syariah indices perform better than conventional indices. There are other studies which show an evidence for attractiveness of similar type of ethical securities for investment. Teets Hickman, Briston (1995) and Statman (2000) Kohls (1999), all acknowledged that ethical funds associated with lower risk as compared to conventional funds. Though there is generally no significant difference in the return between the KLSE SI (Kuala Lumpur Stock Exchange Syariah Index and KLSE CI, conventional Index. Studies regarding risk differential between Syariah and conventional stocks have done by scholars (McGuire, Schneeweis and Sundgren, 1998) who established that ethical stocks associates with lower risk as compare to traditional stocks. For instance, Sauer (1997), Guerard (1997), Ditz established that there is no statistical difference between non-ethical and ethical portfolio in United State. Researcher like Power, Gray, Krenander (2005) did analyses on SRI funds (socially responsible stocks) in 7 countries; For instance, UK, Germany, Belgium , Norway, Switzerland, Netherland and they found that there was no statistical difference in the performance between conventional and socially ethical funds.

According to efficient portfolio theory, stocks with higher risk yield higher returns and vice versa.

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Firstly, scrupulous Islamic principles of transaction (Mu'amalat) restrict the company's ability to achieve maintainable growth and external source of financing; secondly, limitation on the investment opportunities potentially reduce the expected revenues of the company (McGowan & Junaina, 2010)

1.3   Research Objectives

The main objective of this study is to evaluate and analyze the financial performance of Syariah complaint stocks in comparison to conventional stocks portfolio listed in Malaysia stock market by employing statistical modelling independent t-test. Whereby this study will also contributes positively towards understanding and enhancement of Islamic financial industry. The financial performance of both Syariah and conventional portfolio is examined by calculating and comparing the risk and return of both portfolios. Risk is evaluated by looking at the standard deviation on weekly average stock prices and return is calculated by calculating the stock price differences by using the formula as mentioned in the methodology section. In addition, this study also looks at the relationship between the financial ratios and stocks return for each portfolio of Syariah compliant stocks of companies and non- Syariah companies.

The main objectives of this study are:

1. To investigate the risk and return of Islamic funds thoroughly by using a hypothetical portfolio consist of Syariah compliant stocks with conventional stocks registered in Malaysian stock exchange.

   A detailed analysis of risk and return will help to explain whether the risk and return on Islamic funds are admissible or not. The risk and return are determined based upon the analysis of a hypothetical Syariah complaint portfolio rather than mutual funds or unit trust. In this research the risk of sample biasness is controlled by selecting stocks randomly from various industries sectors irrespective of stocks performance.

2. To investigate relationship between financial ratios and the respective stock returns of Syariah complaint stocks and conventional stock returns.

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Financial ratios are very important and fundamental parameter used in evaluating the financial performance of a company before decision of an investment. An investor has to ensure that the information provided in the financial statements are correct and represent true and fair view about the company based on these information market price are determined (Anisa,2011).

Based on the above discussion, two questions are formulated which define the objectives:

1. What are the basic characteristics of risk and return of Islamic based portfolio?

This study will try to investigate either the risk and return of Syariah complaint stocks are significantly different from conventional stocks. In terms of investment knowledge, Islamic stocks are constrained by Syariah screening process like only halal (religiously permissible), free from interest based securities such as insurance companies and conventional banking system which is completely forbidden (haram) and activities like gambling which is full of uncertainty (gharar), production of alcohol, pork products and tobacco products which are socially unethical or hazardous for society. By looking at the risk and return of Islamic funds it is possible to identify the factors which affects or contribute in the performance of funds.

2. Is the performance of conventional based portfolio different from Islamic based portfolio in terms of risk and return?

This study tries to analyze whether there is a significant difference in the performance between Syariah and conventional stocks in terms of risk and return. This study is important because earlier research findings are inconclusive. In earlier studies, Islamic funds are underperformed, over performed and showed no difference between Islamic and conventional funds. The contradictions in the results are linked to sample choice and time period. The trend can be observed by looking at the latest updated observations to find the significance and updated viability of investments in Islamic funds.

3. What is the relationship between conventional and Syariah portfolio returns in comparison to financial rations (Price to Book value, Return on Equity, Net profit Margin, Earning per share, Debt to Equity Ratio)?