Why are Investors Increasingly Attracted to SRIs?

Performance of SRIs has Surprised the Sceptics

Studies on the performance of SRIs are increasing. Advocates of socially responsible investment maintain that SRIs contribute non-financial advantages that are often unquantifiable in value and extend beyond performance, especially over the short-term. Opponents argue that social and moral screening will reduce diversification opportunities.¹

It’s also argued that such portfolios can be inefficient as they limit the choice of an investor by creating investment constraints.² Finally, portfolios concentrating on socially responsible firms will be more exposed to specific risks as they introduce industry and style biases.³

However, a glance at performance globally indicates that trends are actually unexpected. SRIs, although beginning from a lower base, have quickly aligned themselves with the levels of conventional funds proving that performance is in fact not compromised through SRI investment. Hence, if value is increased in unquantifiable factors and performance does not suffer then the obvious question must be considered: What prevents an Investor from opting for responsible investment?

¹ Barnett and Salomon, 2006
² Adler and Kritzman, 2008
³ Rudd, 1981; Kurtz, 1997; DiBartolomeo and Kurtz, 1999
International Regulation Supporting SRIs

Global moves in promoting SRIs have been led from the highest levels of government and regulation. Governments are increasing their initiatives for SRIs, and this has been a contributing factor in the recent surge for ‘saint stocks’ and avoiding ‘sin stocks’ in contemporary investment portfolios. Belgium, Italy, Sweden and the United Kingdom encourage such investments by requiring pension fund managers to disclose the extent of their involvement in social and ethical securities.

South Africa, the Netherlands and the UK are some of the earliest to have introduced SRI-related regulation. For instance, South Africa established the ‘King Committee’ in 1992 to encourage Corporate Governance practices among corporates. This pioneering effort is regarded as the most complete report on corporate governance practices ever produced at the time. The report not only included regulatory and financial aspects of corporate governance but also covered the essential axioms of ethical and socially responsible firm practice. The King Report (as it became known) was amended and updated twice, first in 2002 (King II) and then in 2009 (King III). King III has become the global benchmark for corporate governance, contributing to a dramatic shift in corporate board structures and governance practice. In fact, for a firm to be listed on the Johannesburg Stock Exchange (JSE) and the Socially Responsible Investment (SRI) Index, it must adhere to the principles of King III.

SRI Initiative in Europe

Developed economies in Europe are effectively buoying towards SRIs via incentives and new promulgations. The Netherlands for example, has systematically introduced certain acts (Dutch Market Abuse (Financial Supervision Act)) and codes (Dutch Corporate Governance Code) to encourage firms to be ethical and socially responsible. In 1995, the Netherlands provided tax relief under the ‘Green Investment Directive’ incentivising proactive SRI-compliant firms. Under the ‘Green Investment Directive’, firms involved in clean energy production including wind and solar energy and firms farming organically have all benefitted from tax relief.

On the other hand, firms providing loans and acquiring shares in landmine and cluster munitions manufacturers was outlawed through a newly introduced act called the ‘Dutch Market Abuse (Financial Supervision Act)’.

Germany and the United Kingdom have also used similar strategies in emphasising the importance of SRI. For instance Germany, in 1991, established ‘The Renewable Energy Act’ under which it provides tax benefits to mutual funds that invest in wind-energy.

The UK, in 1999, amended the 1995 Pensions Act disclosure regulation to include the extent to which these funds invested ethically. By 2000, the UK government established the ‘Trustee Act’, with the objective of amending the rules governing trustees and persons having investment powers of trustees. Under this act, it was prescribed that charities must be invested ethically. More recently, the UK established ‘Stewardship Code, 2009’ initially intended for institutional investors investing in UK listed firms. The Code consists of principles and guidelines that relate to stewardship responsibilities and like the ‘UK Corporate Governance Code’, the ‘Stewardship Code’ is also based on ‘comply or explain’ basis. The Financial Services Authority in the UK requires authorised fund managers to disclose “the nature of its commitment” to the Code or “where it does not commit to the Code, its alternative investment strategy” (under Conduct of Business Rule 2.2.3). In the last five years or so, other emerging countries such as China, India, Indonesia, Malaysia and Pakistan have also taken initiatives to encourage firms and asset management companies to include certain ethical social considerations in their investments.

\(^4\) Renneboog et al., 2008
Amendment to the Danish Financial Statements Act
“Mandatory ESG disclosure for companies and investors. Information must include:
• Policies on corporate social responsibility.
• Implementation methods.
• An evaluation of what has been achieved through corporate social responsibility, in the last financial year, and what is expected for the future.”

Table 1: Regulatory standards and regulation regarding SRIs
Corporate Governance: A guide for fund managers and corporations

Guidelines for determining approach to Corporate Governance, voting and other issues proposed by public companies in which a fund invests.

NGER Act

The National Greenhouse and Energy Reporting (NGER) Scheme was introduced in 2007 to provide data and accounting in relation to greenhouse gas emissions and energy consumption and production.

CSR Voluntary Guidelines

Business entities should formulate a CSR policy to guide its strategic planning and provide a roadmap for its CSR initiatives, which should be an integral part of overall business policy and aligned with its business goals.

Stewardship Securities

A voluntary guide for listed companies on sustainability reporting.

Securities

Companies concerned will need to disclose information on policies, risks and outcomes as regards environmental matters, social and employee-related aspects, respect for human rights, anti-corruption and bribery issues, and diversity in their board of directors.

Securities

A principle-based code for corporates, now a requirement of listing on the JSE, including integrated sustainability reporting, in King II (2002).

Reg 28 of the Pension Funds Act

Integration of ESG considerations to fiduciary duty.

Regulation No. 47/2012

Article 2 of the GR provides that every company has social and environmental responsibility. Article 3 provides further in its section I that this social and environmental responsibility is an obligation for companies that are engaged in the business field of or related natural resources.

Amendment in regulations concerning pensions funds

Information of pension funds to clients how ESG issues are considered in the use of deposited funds when signing the contract, and in annual report board of directors.

Sustainability Reporting (Singapore Exchange)

A voluntary guide for listed companies on sustainability reporting.

Social Responsibility Instructions to Listed Companies (Shenzhen Stock Exchange)

A requirement for companies to formulate environmental protection policies based on their impact on the environment to greenhouse gas emissions and energy consumption and production.

The Code is intended to give institutional investors guidance on effective exercise of stewardship responsibilities to ensure delivery of sustainable long-term value to their ultimate beneficiaries or clients.

Reg 28 of the Pension Funds Act

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SRI Opportunities have Broadened with Shariah-compliant Investments

SRIs have been shown to trace back to religious roots and practices. It is no surprise therefore, that the recent growth of investing and finance that agree with Islamic tenets, owes it success to its high ethical values and ‘responsible investing’ philosophy. Islamic investment can be seen both as a niche form of SRIs and as a unique investment class in its own right. The word ‘Islamic’ refers to where the philosophy is founded in terms of the law and lifestyle, without any restriction or limit on who is involved irrespective of their religious or non-religious affiliation.

The basic premise aims to achieve a business environment that enables all of mankind, Muslims and people of other faiths, to live and thrive in a world where there is justice, prevention of acts against society and the promotion of mutual benefit whilst maintaining the dignity of all parties concerned. As such, real private ownership, open trade for all members of society and the possible creation of wealth across the board are key components of the Islamic philosophy, advancing equitable and feasible generation and distribution of wealth among people. An SRI within the Islamic proposition brings the following elements/advantages to the business scene and the economy/society as a whole:

The Islamic Proposition to SRIs

1. A reduction in uncertainty and in leverage levels in the business community;
2. Establishing a level playing field through reasonable profit-taking and equitable bargaining power for transacting parties;
3. Maintaining stability by removing of business operations based on speculative ends;
4. Eradication of business activities that have destructive objectives on men and nature for the sake of continued and assured economic stability for future generations;
5. Promoting sustainable business and investment activities that entail positive results with stable future prospects and the welfare of men and the societies they live in;
6. Stimulating entrepreneurial vision, trade and industry growth based on sound relationships that span industries, suppliers and customers and on mechanisms that channel wealth and assets originating from capital owners, savings and charitable funds to achieve profits. All this is achieved while providing opportunities for success for those seeking to improve their circumstances. This approach reduces the insular nature of conventional saving and investment schemes;
7. Linking capital markets to real economic activities where capital owners and financial institutions become buyers, sellers and partners instead of creditors. This translates in a more active business environment where investors take part in clearly specified businesses and transactions;
8. As a result of all of the above, greater stability builds its way into the economies of nations, ensuring socio-economic wellbeing and spurs growth in a tenable manner that can be seen in carefully choosing business activities anchored in Sharia and characterised by long term perspectives.
Using Islamic Investment Screens for Tailor-made Investment Portfolios

Placing funds with Islamic fund managers has an added benefit for the savvy portfolio investor. Since the most notable aspect of Shariah-compliant investment involves the screening methodology, Islamic fund managers have advanced and excelled in using software that can filter stocks considerably beyond the conventional, allowing the investor to select stocks based on detailed and technical preferences.

Islamic fund managers have a track record of selecting companies that comply with complex financial and quantitative screening criteria that can now be used based on the unique risk profiles of investors. This means that investors can be especially unique in their portfolio selection, for example accepting or rejecting companies that have changed their gearing, their liquidity, and even their interest-based income. Whilst the standard Shariah-compliant investment criteria have the obvious advantages of selecting good-value stocks that have lower conventional gearing, these screening filters can be adjusted to suit investor preferences.

As far as the original screening filter of these investments are concerned, it is clear from the Quakers and Lutheran Brotherhood and even the PAX world fund that was established in 1971, that they were based on negative filters as they refused to invest in firms that dealt with arms and ammunitions and slave trading amongst other dubious businesses. These negative screenings were based on ethical, socially responsible and environmental protection criteria.

Some of these funds use certain thresholds to allow degrees of flexibility such that the exclusion of firms is contingent on reaching a prescribed maximum level fixed by these funds.

Islamic investment funds form a part of this overall consideration with specific screening criteria that have been set through the consensus of authorities in the field of Islamic jurisprudence and finance. Whilst these screening criteria differ in application, the fundamental qualitative and quantitative screening do not, inspiring a fairly standardised approach to selecting the investable universe. Referred to by traditional SRIs as negative screens, Islamic investments apply two key screens:

i. A Qualitative Screen, and
ii. A Set of Quantitative Screens.

Since the very first SRIs, screening filters have been used to include and exclude firms from the investable universe. Some of these widely used criteria are based on environmental protection, human rights, firms engaged in manufacturing arms and ammunition, tobacco, liquor and generally what is referred to as ‘sin stocks’. These screening criteria can broadly be classified into negative and positive filters.
i. Qualitative Screen

The first screen is known as the qualitative or business screen. All businesses involved in the following are excluded immediately from the investable universe. The differences in application between regions differ somewhat and will be explained later.

Table 3: Qualitative or Business Screens for Islamic Investing

<table>
<thead>
<tr>
<th>Qualitative or Business Screens for Islamic Investing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks, conventional insurance companies and financial institutions that derive a significant portion of their income from interest earnings and conventional insurance premiums</td>
</tr>
<tr>
<td>Manufacturers of weapons for domestic or foreign militaries, firearms and ammunitions for public or private use</td>
</tr>
<tr>
<td>Companies that derive a significant portion of their income from the manufacturing or marketing of porcine products or their derivatives</td>
</tr>
<tr>
<td>Publishers, sponsors and/or producers of explicit or offensive material including lewdness and violence in all its forms</td>
</tr>
<tr>
<td>All producers, marketers, or promoters of alcoholic beverages</td>
</tr>
<tr>
<td>Casinos and suppliers of gambling equipment</td>
</tr>
<tr>
<td>All manufacturers of tobacco products</td>
</tr>
</tbody>
</table>

Table 3: Qualitative or Business Screens for Islamic investing
ii. Quantitative Screen

The second set of screens is known as the financial or quantitative screen.

<table>
<thead>
<tr>
<th>Financial Screen</th>
<th>Dow Jones Islamic Index</th>
<th>FTSE Islamic Index</th>
<th>MSCI Islamic Index</th>
<th>Bursa Malaysia Shariah Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>01 Leverage (Debt/Equity)</td>
<td>Debt/ 2 Yr Average Market Cap &lt; 33%</td>
<td>Debt / Total Assets &lt; 33%</td>
<td>Debt / Total Assets &lt; 33.33%</td>
<td>Debt / Total Assets &lt; 33%</td>
</tr>
<tr>
<td>02 Liquidity (Accounts Receivable + Cash)</td>
<td>Acc Rcvbl + Cash / 2 yr Average Market Cap &lt; 33%</td>
<td>Acc Rcvbl + Cash / Total Assets &lt; 50%</td>
<td>Acc Rcvbl + Cash / Total Assets &lt; 70%</td>
<td>Cash / Total Assets &lt; 33%</td>
</tr>
<tr>
<td>03 Impermissible Income⁵</td>
<td>Revenue from Prohibited Items + Total Interest / 2 yr Ave Market Cap &lt; 5%</td>
<td>Revenue from Prohibited Items + Total Interest / Total Assets &lt; 5%</td>
<td>Revenue from Prohibited Items + Total Interest / Total Assets &lt; 5%</td>
<td>Revenue from Prohibited Items⁵ + Total Interest / Total Assets &lt; 5%</td>
</tr>
<tr>
<td>04 Cash &amp; Interest-Bearing Instruments</td>
<td>Cash + Interest Bearing Instruments / 2 yr Ave Market Cap &lt; 33%</td>
<td>Cash + Interest Bearing Instruments / Total Assets &lt; 33%</td>
<td>Cash + Interest Bearing Instruments / Total Assets &lt; 33.33%</td>
<td>N/A</td>
</tr>
</tbody>
</table>

⁵ Income for non-compliant activity including interest income⁶ Association of the Luxembourg Fund Industry
⁶ Slight differences exist in the categorization of prohibited items between Bursa Malaysia and the other indices. Additional qualitative analysis including the image or public perception of the company, its importance to the community and its social responsibility is also considered.
Comparative Risk-Adjusted Movements in SRI Returns

1 Sharpe Comparisons of Islamic/ Ethical Markets vs Conventional Investments

Overall Islamic funds /ESG returns began from a lower base and have been driven down by market perception that has been socially-motivated as opposed to profit-motivated returns being less focused on shareholder maximisation.

Negative sentiment pervades during the financial crisis when investors lack confidence and have distrust for the market move into interest-based safe-havens.

However, in the long-term, Islamic funds/ ESG have proven their resilience and as markets become more stable, confidence in these forms of investment increases.

Returns are closely matched, indicating no loss of return in Islamic funds over the long-term.

Figure 1: Sharpe Ratios for the Islamic and Ethical Market combined, versus the overall Market
Source: EurekaHedge
Islamic investment returns were in fact closer to general market movements before the crisis, probably due to a variety of reasons including lack of awareness in the functioning of these investments.

As awareness and overall understanding increases, Islamic investments tend to buck the trend at financial crisis.

Overall, Islamic investments on a risk-adjusted basis prove to be as good if not better investments over the long-term.

Figure 2: Sharpe Ratios for the Islamic Market alone versus the overall Market
Source: EurekaHedge
The overall joint distribution of the number of Islamic / Ethical funds in 2015, when compared to Islamic funds alone, shows that the vast majority of Ethical funds in the MENA and Asia-Pacific region are actually Islamic funds (96% of MENA funds and 80% of Asia-Pacific Funds).

**Figure 3:** Global Distribution of Islamic and Ethical Funds—combined in terms of No. of Funds  
Source: Eurekahedge

**Figure 4:** Global Distribution of Islamic Funds only, in terms of No. of Funds  
Source: Eurekahedge
Islamic fund size globally has continued its growth path since 2008 with a CAGR of 9.1% between 2008 and 2013. By 3Q2014, the sector was valued at USD75.8 billion. The steady growth of the niche market indicates the limited effects of geo-political sensitivities since 2011 upon the sector and a sustained growth pattern that is expected to pass the $100 billion mark within the next 2 to 3 years.

Source: ISRA and Zawya

At the end of June 2015, a total of 1,018 active funds were on the market based on Islamic investment principles. Saudi Arabia and Malaysia jointly manage approximately 69% of the total Islamic funds in terms of assets under management.

Source: ISRA and Zawya
As the global economy is expected to build on the gains made in 2013 and 2014, a growth of 3.8% is forecasted.\(^7\)

Emerging markets are expected to enjoy a significant portion of this growth and stronger trade demand is pushing countries in Asia Pacific and the Middle East towards an improved future outlook. With the concentration of Islamic funds in the Asia-Pacific and MENA, these investments are expected to benefit directly from forecasted market movements.

Certain jurisdictions like Saudi Arabia (capital market reforms allowing foreign investment\(^8\)) and Malaysia have the advantage of enhanced regulation (IFSA 2013) that pave the way for a more harmonised approach to Islamic finance and investment between the MENA and Asia Pacific regions, exceedingly benefitting the global Islamic investment market.

In 2014, Malaysia, Singapore and Thailand were signatories to a cross-border framework for fund managers, making the process of distribution between countries more efficient.\(^9\)

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\(^7\) International Monetary Fund (IMF) forecasts for economic data (October 2014)

\(^8\) “Saudi Arabia prepares to open USD530bn bourse to foreigners”, Zawya (July 2014)

\(^9\) “Investors in 3 Asean markets get wider range of options”, Asia One Business (August 2014)
Several factors could have contributed to the dip in performance beginning late 2002 to 2006. To begin with, the stock market crash of 2002 affected the US, Canada and Europe significantly. As stock markets recovered from the 9/11 terrorist attack, several high profile corporate frauds (Arthur Anderson, Enron and Worldcom) added fuel to the already burning stock markets. The mutual fund scandal of 2003 in which some of the mutual funds companies were accused of late-trading and market timing practices\textsuperscript{10} was the final straw, driving markets down. At least 20 mutual fund companies were involved in the illegal trading scandal that had violated securities laws. Some of these firms were the industry’s largest firms as they managed more than a thousand with total assets under management of over $1 trillion. It can be argued that corporate frauds coupled with the mutual fund scandal could have done more damage to the ethical fund industry than the stock market crash as the market has a long memory and customer confidence was damaged. All these incidences can provide a connection to the decline in the Sharpe ratio from 2003 to 2006. However, the reason for the slow recovery could be the fact that most of the countries did not have sufficient regulation that would be able to govern and regulate firms. As regions began enhancing and implementing regulation, markets have improved, experiencing a noteworthy recovery.

As the comparison has shown, Shariah-compliant investments have provided an alternative to traditional investment and as more conscientious investment decisions are made, investor demand in responsible investment is already driving change in the industry. Shariah-compliant investments have proven themselves over the investment horizon as a stable long-term investment that, when managed in well-regulated environments, can provide sustainable returns at manageable risk. Malaysia is at the forefront of Shariah-compliant investments sophistication and experience, possessing some of the most accomplished and proficient Islamic Fund Managers the industry has to offer.

A rapidly expanding trend towards SRIs has gained an unprecedented pattern of growth from both the North American and European regions. Although, the religious origin of SRIs instill no surprise that Islamic investments have inherent SRI characteristics.

The overall objectives of Islamic investments in terms of the reduction of uncertainty, removal of business with immoral objectives and the encouragement towards real sector development promote superior stability without compromising return over the long-term.

The next section discusses emerging market growth and what is required to enhance that growth. Innovative solutions that are market-related can be found within the Islamic finance sphere including sukuk, real sector investment & finance and SRI endowment options.

The challenge is identifying Shariah-compliant SRI initiatives within a robust regulatory environment that has a track record over the medium to long-term. The Malaysian option presents that option as a global leader in Islamic finance innovation, offering a robust solution for investment that can be adapted to suit both individual and institutional requirements.