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Sustainability, Islamic Finance and Managing Risks While Seizing Opportunities

In times of a financial crisis, it is only natural to look for means and measures to prevent such a meltdown from ever materializing again. To that end, two sectors in the financial industry are receiving more in-depth media coverage than ever before: One is the field of sustainability banking, the other Islamic finance. What are these approaches about, and what could their contribution be to portfolio management?

Sustainability comes originally from the sector of forestry, where long-term, inter-generational planning is required to plant and cut trees in an ongoing manner, so that future generations can do the same. This status of equilibrium requires substantial discipline not to forego the long-term root of living for short-term gains. In portfolio management, sustainability considers – aside from financial criteria – social and environmental issues. It goes above and beyond socially responsible investing by considering positive screens and promoting investment in companies with best practices, rather than just screening out those with negative aspects, like harmful industries and bad practices (e.g., child labor or land mines).

Islamic finance as an investment approach is based on the concepts of Islamic teachings. Since its modern origins in the 1970s, it has increasingly gained market share, especially in the Middle East. Islamic finance and sustainability approaches have a lot in common, but are not identical. Currently, Islamic finance is dominated by negative criteria similar to the responsible investing movement; as such, the Dow Jones Islamic Market Index[SM] excludes the following primary businesses: alcohol, tobacco, pork-related products, financial services, defense/weapons and entertainment. Specific to the Islamic criteria is the exclusion of financial services and the application of the so-called Shari'ah tolerance criteria in regard to the financial ratios of the companies themselves. In the index methodology, they are defined as follows:

- Total debt divided by trailing 12-month average market capitalization cannot be 33% or more.
- Cash plus interest-bearing securities divided by trailing 12-month average market capitalization cannot be 33% or more.
- Accounts receivables divided by 12-month average market capitalization cannot be 33% or more.

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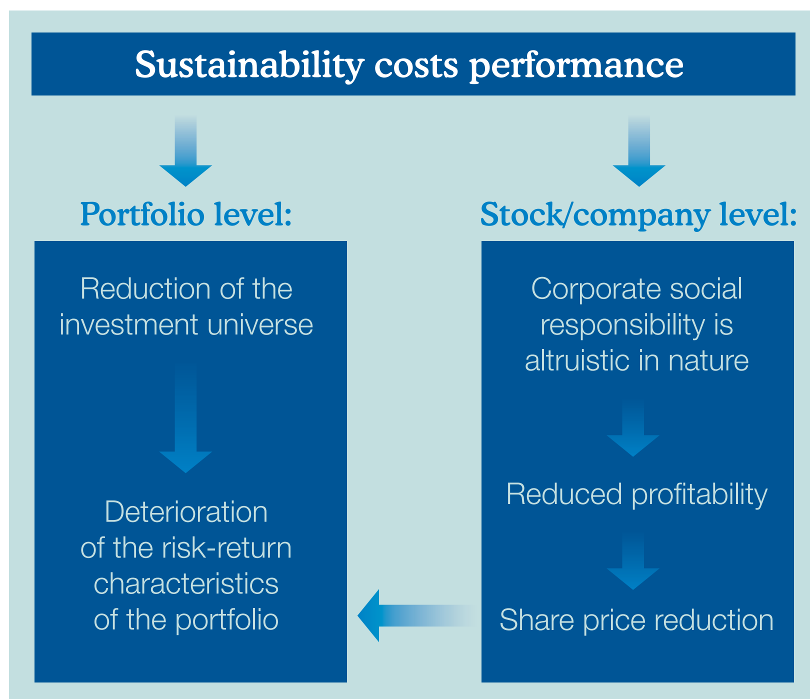
Sustainability and Performance: Two Lines of Argument



Source: Bank Sarasin & Co. Ltd.

In this regard, Islamic finance differs from the sustainability movement by focusing on negative industry screens and financial ratios, while sustainability emphasizes economic, social and environmental issues.

From a portfolio management point of view, it is crucial to see the impact of such criteria on the overall risk/return profile. Bank Sarasin published a study on sustainability and its impact on stock performance in cooperation with the Center for Corporate Responsibility and Sustainability at the University of Zurich and the ZEW Centre for European Economic Research, reviewing former studies and running an additional empirical test.

The thesis, that sustainability criteria have a negative impact on performance, is usually argued along two lines:

1. Portfolio Level: The reduced number of eligible shares reduces the investment universe, hence the opportunities for an optimum risk/return profile.

2. Stock Level: Corporate Social Responsibility (CSR) is seen as altruistic, and therefore reduces profits, which in turn can reduce stock price.

Answering these two claims, the study argues that although the theoretical reduction of the universe would incur costs, it is not fully relevant – even conventionally analyzed investment universes contain only a few hundred stocks; hence, there are sufficient eligible shares to choose from in an investment universe screened for sustainability. Sustainability can even expand the universe by looking to include stocks otherwise set aside for reasons such as relatively low market capitalization, even though they might be forming strategic opportunities due to innovative products, e.g., in the fields of energy or water.

Regarding the individual stocks' profitability by employing higher CSR standards, the study emphasizes that such standards prevent reputation risks, but also can incur higher compliance costs, for instance with environmental standards. Last but not least, the study maintains that higher CSR standards enable companies to find much-needed business solutions for society, which are profitable in the end. Certain preventive measures are becoming more important over time, such as climate change and energy costs; eventually, these will materialize into effects on individual stocks.

Bank Sarasin analyzes sustainability in two dimensions. First, it rates the sustainability of all industries, identifying the specific risks and opportunities. In a second step, each company is compared to its peers in terms of how it handles these challenges. This approach allows control of the sustainability risks because the threshold for companies of an unsustainable industry can be set higher than those for companies in more sustainable industries. This approach was made subject to an empirical analysis, resulting in a positive impact of this selection screen toward financial performance. Even though each analysis can be challenged, the majority of external studies came to the conclusion that sustainability does not incur costs for financial performance. The additional value identified is the long-term risk management associated with business sectors, which are operating with high social and environmental risks.

The study, however, did not elaborate specifically on Islamic screening criteria, although the question asked is valid: Are the screening criteria adopted coming at a cost, are they neutral or do they even form a good and sound investment rule? Few studies have been published on the selection criteria adopted by the Islamic finance community.

Analysis for the Islamic mutual fund industry has shown, so far, that there is no inferior income, or in other words, no penalty and no financial reward associated with using Islamic screening criteria. Elfakhani/Hassan (*Performance of Islamic Mutual Funds*, Elfakhani, Said and Hassan, M. Kabir, Cairo, Egypt, 2005) recommends that conventional investors consider Islamic mutual funds because they contribute value during slow market periods. Hayat (*An Empirical Assessment of Islamic Equity Fund Returns*, Raphie Hayat, Amsterdam, The Netherlands, 2006) also emphasizes the aspect of diversification, because the systematic risk-to-return ratio adds value. Islamic mutual funds might be a good hedging instrument for any equity investor in market downturns and recessions, according to Elfakhani/Hassan.

While Hussein identified an outperformance in bull markets, the results of empirical index analysis have shown some underperformance in bear markets, and the analysis indicated higher risks for Islamic funds than for their non-Islamic peers. Contrary to these findings are the conclusions of Hakim/Rashidian (*Risk & Return of Islamic Stock Market Indexes*, Economic Research Forum Annual Meetings, Hakim, Sam and Rashidian, Manochehr, Sharjah, UAE, 2002), which suggest that outperformance is a given (even in bear markets), but additionally suggest a substantially lower risk profile: The standard deviation was slightly better for the Dow Jones Islamic Market World Index℠ than for the much more broadly constituted Dow Jones Wilshire 5000℠ (22% and 24%, respectively). The Sharpe ratio difference was even more astounding: 118% compared to 194%! The diversification value is, according to the study, further enhanced because the Islamic index is influenced by factors other than the broader market or interest rates.

The screening criteria do exclude financial stocks and all those with more than moderate debt. As such, the Islamic indexes benefited in the most recent crisis; and the lower leverage of the firms contributed to limit risk factors. Overall, the findings of both sectors suggest that ethical screens are a sensible approach to managing risks.

A study combining both sets of parameters, sustainability and Islamic finance, has still to be undertaken, but the rising awareness in the media is based on proper common sense. Ethics do not come at a cost; they provide a value. More research shall focus on which ethical criteria add to the performance and risk management in order to make ethical screens a standard tool for portfolio management.

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Source: *Sustainability and share performance - a long-running debate*, Basel, Switzerland, 2008.