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In focus

The alignment of Shariah and sustainable investing

November 2019

This paper makes the case that investors who embrace Shariah principles should also aspire to adopt the ideas of sustainable investing. Our analysis shows that the two sets of principles have a high degree of overlap. We believe that the providers of Shariah funds should move beyond basic Shariah-based exclusion of industries and companies from their investment universe to an approach which more fully respects the Islamic values of socio-economic justice and overall well-being.

Duncan Lamont
Head of Research
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Shariah investing

The approximately 1.8 billion Muslims globally represent around a quarter of all people on Earth. However, despite their numbers, Muslims have been underserved by the asset management industry, with limited innovation in product offerings and low growth in assets. This comes at a time when there has been rapid growth in demand for sustainable investment strategies. This illuminates a paradox. That is, the rules that govern Shariah are set in terms that echo the framework of sustainable investing, yet Shariah investing has gained limited traction.

The content and blueprint of Shariah investing is derived by extracting the general rules of Shariah investing from the Quran and Sunnah[1] in order to achieve the ideal Islamic economy[2]. The hallmark component of the rules is the pursuit of justice[3] in all economic endeavours in order to help all members of society achieve equitable growth. Islamic or Shariah investing can be captured in five principles[4]:

- Support of activities that promote benefits to society.
- Prohibition of interest-bearing instruments and practices that aim to cultivate unjust gains such as speculation, short selling or excessive risk-taking.
- Sharing of risk and rewards on an equitable basis.
- Transactions comply with rules that ordain amongst others trust, faithfulness to contracts, transparency and prohibition of interference or manipulation of market forces as well as coalitions.
- Exclusion of prohibited goods or services that are harmful to humans and society as defined by the Shariah (pork, alcohol, gambling, drugs, etc.).

1 The teachings of the Prophet Muhammad (pbuh).

2 "The Ideal Islamic economy is a sharing economy, it is enterprising, purposeful, prosperous in which all members of society receive their just rewards" Askariet. al(2015).

3 Economic justice envisioned in Islam does not relate to equal incomes and wealth nor does it translate into a socialist economic system. Muslims are told to earn and enjoy wealth with the injection of a moral responsibility by way of contribution to the less able members of society.

4 Source: Maybank Islamic.

"Although it has previously received less attention within the Islamic finance fraternity, sustainable investment is, in fact, an embedded principle in Islamic finance. Islam emphasises extensively the sustainable development and protection of the life, which is one of the general purposes of the Shariah (maqasid Shariah). Of course, this notion of sustainable investment should be understood and interpreted within the principles of Shariah. Hence, the alignment of Shariah and sustainable investment as advocated by this report is very timely and highly commendable. I congratulate the team for preparing this important research."

Assoc. Prof. Dr. Aznan Hasan
Chairman of the Shariah Committee,
Maybank Islamic Berhad

"Historically investors who were interested in investing according to their values were limited to just focusing on what a company produced. Shariah-compliant investments are a prime example. But we all know that how a company conducts its business is equally important, especially when evaluating the impact on the wider world. As sustainable analysis and data grows, Muslim investors now have the opportunity to move beyond mere compliance, to holistically express their values and assess the impacts of their investments. A shift towards a more explicit focus on sustainability is both in keeping with the teachings of Islam and aligned with what investors worldwide are increasingly demanding."

Jessica Ground,
Global Head of Stewardship, Schroders

In collaboration with

Schroders

Development of Shariah investment funds

Traditional Shariah fund offerings exclude companies which do not comply with Shariah principles. Typically a listed company with up to 5% of its revenues from non-Halal activities is tolerable for investment purposes. These activities include alcohol, gambling, adult entertainment and non-Shariah-compliant finance. The prohibition of interest, or riba, under Shariah law means that companies which exceed prescribed limits on the portfolio of debt or cash are also not permitted. Environmental impact is not normally a consideration. Appendix 1 sets out a comprehensive list of common criteria and maps them against issues pertinent to sustainable investing.

The impact of these exclusions on the investable universe is considerable. Over 60% of the companies in the Dow Jones Global index fail one or more of the Shariah criteria used to construct the Dow Jones Islamic Market World index (DJ Islamic World). There are 6,904 constituents in the Dow Jones Global index and 2,639 in the DJ Islamic World.

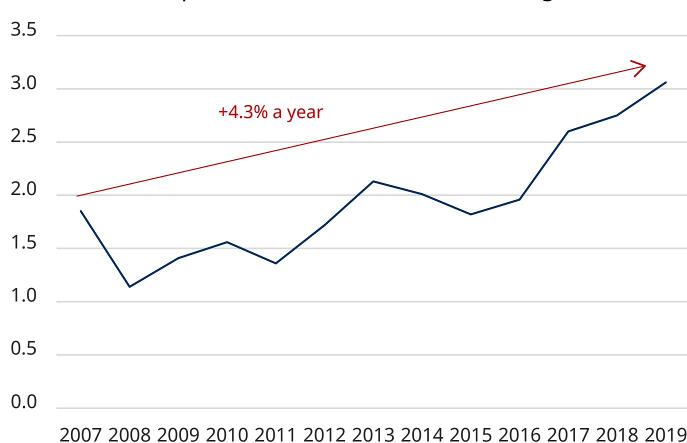
Despite the large potential investor base, the Shariah-compliant investment space has struggled to gain traction. As of June 2019, there remained only $3 billion invested globally in Shariah global equity funds, according to our analysis of data from Broadridge (Figure 1). In addition, the majority of Shariah funds have struggled to achieve scale – in 2017, 69% of funds had assets under management of less than $25 million, according to the Islamic Financial Services Board[5]. Furthermore, despite being a relatively immature market, which would normally be expected to grow faster, assets under management in the Shariah sector have been growing more slowly than those invested in the broader equity market. In relative terms, it has been falling further out of favour.

5 Islamic Financial Services Industry Stability Report 2018.

Figure 1: The Shariah universe is small and growing slowly

Global equities, $ billion assets under management

Global Shariah equities, $ billion assets under management



Source: Broadridge, as at July 2019.

A brief history of sustainable investing

Sustainable or responsible investment has existed for as long as investing has existed. For example, as long ago as the 18th century, the Quakers (a group of religious movements, which grew out of Christianity but now incorporates aspects of other faiths and religions (formally known as the Religious Society of Friends), barred its members from buying or selling slaves, even though it was commonplace at the time. Also, in his sermon on "The use of money" in 1750, John Wesley, the founder of the Methodist church, set out his principles on how individuals should manage their relationship with money, specifically calling for more responsible behaviour[6]. For example, he called for the avoidance of any pursuit of money which would hurt the wealth or health of one's neighbour. Pawn broking and the sale of alcohol (other than for medical reasons) were also specifically ruled out. He furthermore argued against engaging in business practices which could harm others, such as selling goods below market price to drive them out of business.

The industry has evolved considerably from those early days. Religion often helped set the tone for prohibited activities – for example, alcohol and gambling have both come under fire at times.

Over time, sustainable investing grew out of its religious roots, gaining wider acceptance and tackling a broader range of issues. In the second half of the 20th century, environmental considerations started to grow in prominence. The negative consequences of human activity on our environment have received particular attention, a focus which has intensified more recently.

As the fund management industry grew, activists recognised the opportunity that shareholders had to influence corporate behaviour. Between the 1970s and 90s for instance, pressure on fund managers to avoid investing in companies operating in South Africa is held up as one of the factors that ended apartheid.

Initially, exclusionary approaches dominated, as is currently the case for Shariah investments. However, in recent years, investors have increasingly taken more integrated approaches. In these, more traditional investment strategies enhance their stock evaluation process by specifically incorporating sustainability considerations, as opposed to them residing solely in a stand-alone strategy. It has moved from the side-lines to being a component of many mainstream strategies.

For more information, see A short history of responsible investing, Schroders, November 2016 or The origins of socially responsible investing, The Balance, June 2019.

6 Sermon 50: The use of Money, John Wesley, 1750.

Despite the parallels, Shariah investing has not capitalised on the growth of the sustainable investing industry

The slow growth of the Shariah investing industry can be contrasted with another sector with which it has many similarities: sustainable investing. There are many variants of sustainable investing, each with a specific focus, but a common underlying principle is to incorporate how a company interacts with society and its environment in the investment decision-making process (see boxed section on page 2 for a brief history of sustainable investing). Other common variants include ethical investing, responsible investing, socially responsible investing, Environmental, Social and Governance (ESG) investing, and impact investing, among others.

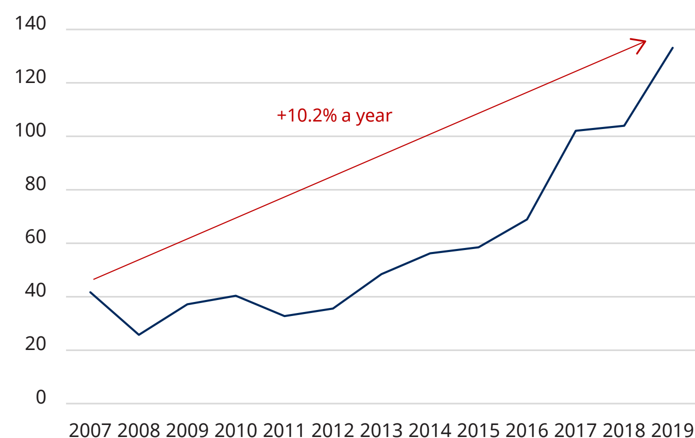
The following definition of ESG investing is derived from Schroders' Environmental, Social and Governance Policy (July 2019):

> "ESG investment covers the range of investment activities which recognise the relationship between companies and the societies and environments in which they operate, and between companies and the shareholders which control them.
>
> ESG integration looks at investment decisions in a wider context than traditional financial analysis and explicitly includes analysis of a range of risks and opportunities related to environmental, social and governance (ESG) drivers. In principle, this can lead to a broader assessment of the environment in which companies operate and their performance in managing different stakeholders, giving a fuller understanding of future opportunities and risks than traditional fundamental analysis. In practice, its effectiveness in doing so hinges on how that integration is approached and implemented.
>
> Responsible investment focuses on companies' citizenship and their contribution to social outcomes. We appreciate that many clients want to use their investment to support more responsibly run businesses. Screening excludes companies involved in controversial activities. We recognise that many investors have concerns over specific activities to which they do not want their investment exposed. Where appropriate, we work with them to define the criteria used to avoid investment in companies operating in those industries and maintain that exclusion on an ongoing basis. Sustainable investment products have ESG analysis as a cornerstone of their investment process. These products look for best in class investments when it comes to ESG performance. As a result they are longer term with their investment horizon, and step away from opportunities that may appear attractive in valuation terms but have challenges on an ESG front. The only universal exclusion from ESG strategies is that of companies involved in the production of cluster munitions, as defined by the Convention on Cluster Munitions."

It is immediately apparent that nothing in this statement conflicts with the aims of Islamic investing. On the contrary, ESG factors play a part in both, even if Shariah investing uses ESG factors for different reasons (see later section for more on this). However, while interest in Shariah investing has been slow to take-off, interest in ESG investing has been accelerating (Figure 2). There is now over $133 billion invested in funds in this sector. This is quadruple the amount invested in this way in 2011.

Figure 2: The popularity of sustainable investing has grown rapidly

Global equities-responsible investments sector, assets under management, $ billions



Source: Broadridge, as at July 2019.

A possible explanation for this divergence is that the current limited range of Shariah-compliant investment products fails to meet Muslim investors' broader preferences, in addition to Shariah-compliance alone. For example, the lack of an explicit focus on sustainability within the majority of Shariah equity funds could be pushing investors who are motivated by ESG considerations to the traditional sustainability arena, as opposed to the Shariah arena. The Schroders 2019 Global Investor Study[7] provides some support for this explanation. 66% of Asian respondents to this survey said they would always consider sustainability factors when selecting an investment product, higher than the 57% globally who agreed with this statement (Figure 3). An even higher percentage felt this way in Indonesia (76%), a predominantly Muslim country. The figure for the United Arab Emirates was also above average, at 62% (individual country-level data not available for other predominantly Muslim countries). Furthermore, Middle Eastern and Asian respondents also felt more strongly than their global peers that climate change will impact their investments.

The Shariah investment industry has, so far, not been able to capitalise on the growing global interest in sustainable investing. However, as already pointed out, sustainable investing is entirely consistent with Islamic principles. The assertion of this paper is that there is an overlap in the normative goals between Shariah and sustainable investing. By integrating the higher level teaching of Islam into how portfolios are built, the appeal of Shariah investing can be broadened considerably.

7 A survey which measured the views of more than 25,000 investors across 32 countries. The survey does not break results down by religion.

Figure 3: Sustainability and climate changes are important factors for Asian and Middle-Eastern investors

	Global	Asia	Indonesia	UAE
I always consider sustainability factors (such as climate risk, diversity, corporate governance etc.) when selecting an investment product	57%	66%	76%	62%
Climate change is having, or will have, a significant impact/some impact on my investments?	63%	67%	78%	73%

Source: Schroders Global Investor Study 2019.

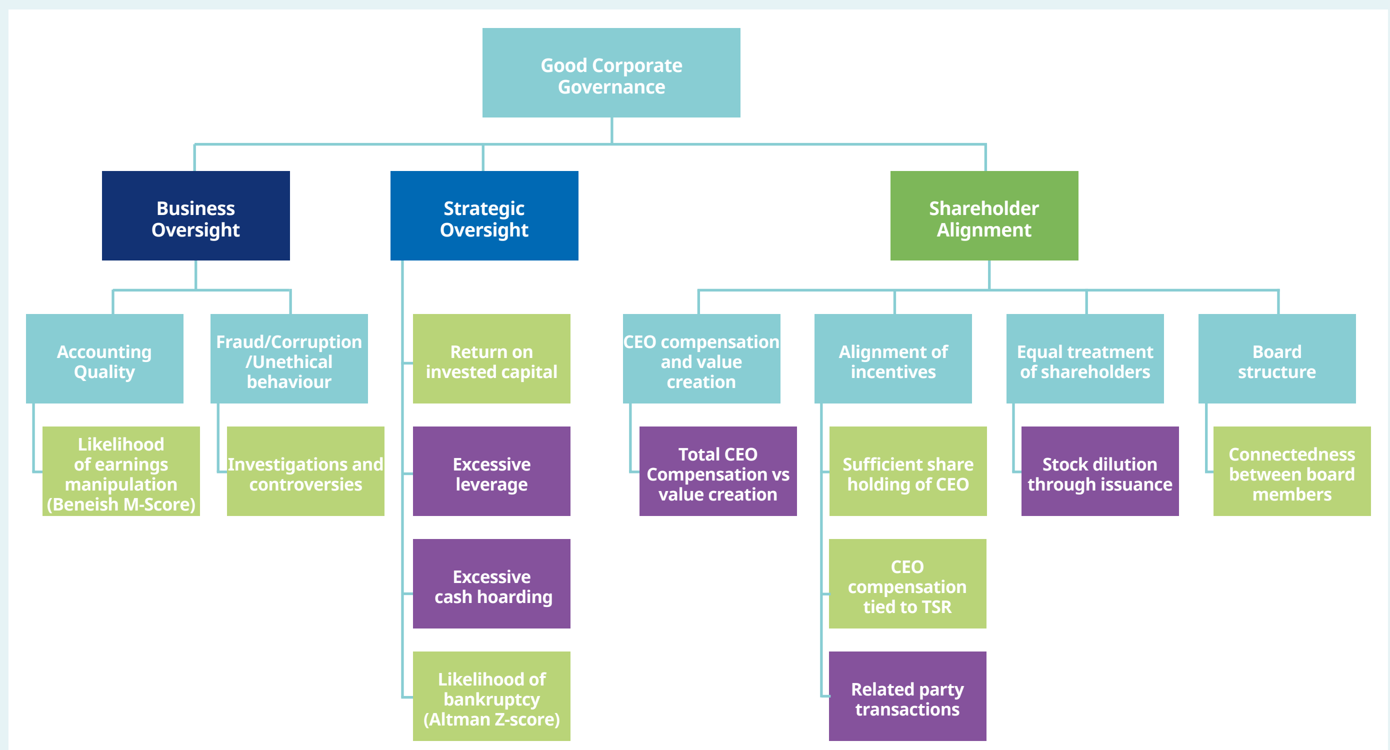
The importance of good governance

While the E and S components of ESG investing may be familiar, the G – governance – is also a vital part of ESG investing. From an operational perspective, studies have found that firms with weak corporate governance are less efficient, have lower labour productivity, and suffer from higher input costs[8]. This is in line with studies providing evidence that companies with strong corporate governance experience lower cost of capital[9]. In similar fashion, Core, Guay & Rusticus[10] find that "firms with weak shareholder rights exhibit significant operating underperformance".

Schroders have also assessed a more comprehensive set of corporate governance indicators than is normally taken account of in corporate governance codes (image below), using data for roughly 1,500 companies over the past five years. Indicators marked in pale green ended up being used in the model, indicators in purple were discarded. This does not mean that they don't matter from a performance perspective, but merely that it was not possible to find a meaningful relationship for the specific time frame and dataset used.

That leverage seems to have relatively little impact feels counterintuitive. However, in the context of the credit cycle of the recent past there are reasonable grounds to assume that this has not really been tested. Nor has the other side of the coin (i.e. cash hoarding) been influential. Again, this may be attributed to the stock market leadership that we have seen from many technology names over the period. Equally, the fact that dilutive stock issuance has not been included in the model would not lead to a change in Schroders' strongly held views on non pre-emptive rights issuance.

This analysis found that companies with top quartile governance scores, aggregated across the areas of business oversight, strategic oversight and shareholder alignment, have better performance than those with bottom quartile scores, after adjusting returns for sector and region. Risk was also found to be lower for companies with top quartile corporate governance scores.



Source: Schroders.

This relationship is not always the case, when corporate governance analysis is limited to assessing compliance with corporate governance codes. For example, Toshiba underwent a series of controversies despite being a model of governance in Japan, with all the right committees and 25% independent directors. In the UK, Carillion, a major listed company, went into liquidation in 2017 after a series of corporate governance failures. The fact that the UK recently celebrated the 25th anniversary of its Corporate Governance Code, the first in the world, was little help. This highlights the importance of looking beyond adherence to corporate governance codes when assessing the G in ESG.

For more information, see Corporate governance – thinking fast and slow, Schroders, May 2019.

8 Giroud and Mueller, 2011. "Corporate Governance, Product Market Competition, and Equity Prices".

9 Ashbaugh, Collins and LaFond, 2004. "Corporate Governance and the Cost of Equity Capital".

10 Core, Guay and Rusitcus, 2006, Does Weak Governance Cause Weak Stock Returns? An Examination of Firm Operating Performance and Investors' Expectations.

ESG considerations are consistent with Shariah principles

Although Shariah and sustainable approaches to investing have developed independently, both have roots in religious principles (see boxed section on page 2 for a brief history of sustainable investing) and both look to bias investment towards more sustainable outcomes. One consequence is that many of the sectors which are excluded under Shariah law also score poorly on sustainability criteria, and are consistently underweighted or excluded from sustainable portfolios as well (see Appendix 1). However, like Shariah investing, where application of Shariah principles is open to interpretation by scholars, there is ambiguity in the application of sustainable or responsible investing. Differing preferences, beliefs and priorities can result in a wide variety of end portfolios. For example, although the majority of sustainable funds do not object to pork-related products, some do, due to the carbon footprint of the industry. Others specifically exclude companies engaged in predatory lending.

The two approaches reflect the differences in their origins. However, the bridge from sustainable investing to Shariah investing is relatively easy to cross. ESG considerations have, so far, received relatively little explicit attention in Shariah-compliant products. However, in our view, the broader principles of Islamic finance suggest a wide range of complementary factors could be considered. In addition, many Muslims wish to invest in line with sustainable principles, in addition to their Islamic beliefs.

The significance of the ordained Islamic teachings stretches beyond investment activities and is meant to pervade day-to-day conduct. The objective of Shariah law or what is known as the Maqasid-al-Shariah, is to promote the welfare of humankind and prevent harm by preserving religion, life, intellect, the interests of future generation, and wealth[11]. The preservation of these frame the scaffolding of an ideal Islamic economic system, in which the interests of society are given great importance. The Islamic view holds that all natural and depletable resources are blessings from Allah (swt) and they are to be managed in trust in order to ensure the rights of this and future generations are preserved. Therefore, Shariah investing widens the focus beyond financial returns to include the overall well-being and welfare of individuals and society at large as well as environmental preservation.

Achievement of a thriving society is enabled through the pursuit of social justice and ensuring sustainable, inclusive and equitable development and growth. These principles should now be fully embraced in Islamic investing. The Islamic finance industry is still developing and, in common with the development of sustainable investing, we expect it to adopt an integrated approach alongside the exclusion of prohibited industries.

This alignment has gained prominence in other aspects of Islamic finance. For example, the Securities Commission of Malaysia issued the Social and Responsible Investing Sukuk framework, one of the first guides linking Islamic Finance with sustainable investing. Several incentives were introduced to facilitate the ecosystem in which investors could utilise Islamic Finance as a fundraising channel for projects relating to natural resources, renewable energy, community and economic development[12] .

The central bank of Malaysia, Bank Negara Malaysia, is promoting value-based intermediation as a vision of how the Islamic finance industry should operate. The initial focus has been on Islamic banking but the planned scope is universal, including asset management. Value-based intermediation is described as:

> "An intermediation function that aims to deliver the intended outcomes of Shariah through practices, conduct and offerings that generate positive and sustainable impact to the economy, community and environment, consistent with the shareholders' sustainable returns and long-term interests"[13]

11 Introduction to Islamic Economics, Askari et. al (2015).

12 Islamic Green Finance: Development, Ecosystem and Prospects SC and the World Bank Group (March 2019).

13 Implementation Guide for Value Based Investing, Bank Negara Malaysia, October 2018.

Bank Negara Malaysia specifically draws attention to the fact that current offerings have focused on compliance. However, it states that "it is essential that greater emphasis should be given to considering the wider impact of the financial activities" and the benefits of shifting "beyond compliance, towards delivering value propositions not only to all financial consumers, but to the wider stakeholders within the society and the economy at large". Bank Negara Malaysia also highlights the similarities between values-based intermediation, ESG and sustainability. For example, one consequence of a shift towards values-based intermediation would be that "any activities that would create damage to the community and the environment, for example pollution or deforestation, will be reduced over time."

Similar moves towards greater promotion of sustainability have been occurring elsewhere in Islamic finance. For example, the Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions' (AAOIFI) set of norms-based standards for corporate and social responsibility (CSR) specifically set out mandated and recommended actions for Islamic financial institutions to follow with regard to ESG factors. These cover areas such as the need to consider the environmental and social impact of a client of an Islamic Financial Institution.
Their holistic approach encapsulates the need to look beyond a narrow application of these standards to a financial institution itself but also to its relationship with customers and suppliers.

If approaches such as these were applied to Shariah investing, it would result in almost complete convergence between Shariah and sustainable investing. This would have been impractical in the past due to data limitations. However, the rapidly growing volume of ESG data that is now available makes it possible to assess public companies against these criteria.

Shariah investing excludes the conventional finance sector

Although there is common ground between sustainable and Shariah investing, there are also aspects that are unique to Shariah investing. In such circumstances, where Shariah compliance is essential, Shariah principles must take precedence.

The most notable divergence is the exclusion of almost the entire conventional finance industry (banks, insurers, asset managers, and others). For example, compared to the 498 stocks in the financial sector of MSCI All Country World index (16.8% of the market), the Dow Jones Islamic World Index contains only 14 (0.7% of the market). These are Middle Eastern banks and insurance companies plus some diversified financials such as Moody's, Standard & Poors and MSCI.

The impact of applying these constraints is covered in more detail in a subsequent section.

Prohibition of interest is not inconsistent with sustainable approaches

The exclusion of companies which pay or receive too much interest is a central pillar of Shariah investing. The most visible impact of this is a notable reduction in leverage levels in Islamic portfolios compared with traditional benchmarks[14]. Figure 4 shows this for the MSCI ACWI Islamic and DJ Islamic World along with the five largest funds in the Shariah sector. Low leverage is also typically one of the main indicators used to assess the "quality" of a company, in a factor exposure sense. Consequently, Shariah portfolios have a strong bias towards the "quality" factor[15].

14 Excessive leverage itself is not prohibited but excessive leverage using interest bearing debt is. However, as the vast majority of global publicly listed companies finance themselves with interest bearing debt, the consequence of this prohibition is an avoidance of more highly levered companies.

15 As an example, whereas the MSCI ACWI has a relatively neutral exposure to the quality factor, the MSCI ACWI Islamic portfolio has a strong positive bias https://www.msci.com/documents/10199/73d7da67-80d8-4c80-a0df-26c1e6f14bb0.

Figure 4: Shariah funds have lower leverage than traditional equity investments

Debt/total capital ratio, %

MSCI ACWI	MSCI ACWI Islamic	DJ Islamic World	Islamic Fund 1	Islamic Fund 2	Islamic Fund 3	Islamic Fund 4	Islamic Fund 5
39.2	27.0	32.8	25.0	28.8	35.2	24.9	34.8

Source: Morningstar, July 2019.

Although sustainable approaches do not normally place rigid constraints on a company's capital structure, there is no reason to believe that doing so compromises a sustainability objective.

On the contrary, there are parallels. A bias away from highly indebted companies is consistent with sustainable investing; high levels of debt are likely to make a business vulnerable to adverse external developments. By reducing some of the potential downside risks during times of stress, resilience and sustainability of returns could be improved. In this sense, leverage restrictions could be considered an additional source of prudence.

In addition, a company sitting on a high cash balance could be an indication of poor corporate governance. As well as being potentially inefficient – it may be better to return excess cash to shareholders – it also increases the risk of cash being squandered on ill-advised acquisitions.

But interpretation of interest restriction has a significant bearing on the investment universe

Although the principle is clear, different market participants interpret the prohibition on companies that derive significant income from interest, or have excessive interest-based leverage, in different ways. This hangs on how the accounting ratio tests are applied. The common approaches to this issue are to compare cash or debt levels either with the book value of a company's assets or with the market value of its equity. As an indication of the lack of consensus on this, two of the most prominent Shariah equity indices, the DJ Islamic World and the MSCI ACWI Islamic index, take opposite approaches. The DJ Islamic World uses a market value test whereas the MSCI ACWI Islamic uses an asset value test. This results in very different portfolios (see Figures 5 and 6).

Companies which have high levels of intangibles may fail the accounting tests on an asset basis but pass them on a market value basis. For example, Apple at June 30 2019 had a ratio of cash and interest bearing-security holdings to total assets (the MSCI test) of 65% but a ratio of only 24% relative to the trailing two-year market value (the Dow Jones test). Many other large technology companies are similarly sitting on levels of cash and interest-bearing securities which are high relative to asset value but less extended relative to market value. One consequence is that the MSCI ACWI Islamic excludes most of the US technology sector, some of the largest companies in the global stock market, but the DJ Islamic World does not.

Although both are valid approaches, we believe that the market value test is more appropriate in today's world, where intangibles are more prevalent. It is also constrains the investment universe much less.

From exclusions to integration

An exclusionary approach filters out certain types of business and reflects an investor expressing a strong set of values – this is consistent with socially responsible investing (SRI), which imposes restrictions based on a set of beliefs, often religious in origin, independent of any judgement on the sustainability of a particular industry or company. Exclusions can also be used from a non-value based perspective: they are a simple way of implementing an ESG strategy, by making a judgement that, for example, withdrawing capital from fossil fuel companies limits their ability to invest in projects that hasten climate change.

An integrated approach is different in that it uses company-specific analysis to focus on companies with more sustainable or responsible business models and does not convey a moral judgement.

From theory to practice: quantifying the similarities and differences between Shariah and sustainable universes

The points discussed so far are inputs to portfolio construction. In this section we consider the implications of these inputs, answering questions such as "how similar are Shariah and sustainable portfolios in reality?" We look at this both from the perspective of country and sector mixes, as well as investment characteristics.

The analysis in this section is based on common industry benchmarks and some of the largest funds in the Shariah sector. Within the Shariah sector, we analyse both the DJ Islamic World and MSCI ACWI Islamic indices, along with four of the largest actively managed Shariah equity funds (the fifth fund which was included in the earlier debt/capital analysis in Figure 4 is excluded from this part of our analysis due to only outdated country allocation data being available). The broad market index used for comparison is the MSCI ACWI index – this is more widely followed than the Dow Jones Global index so is a more representative global equity comparator. This choice does not materially impact our conclusions.

As with Shariah benchmarks, differences in approaches to assessing sustainability and constructing related indices impact their comparisons with the Shariah portfolios. As a result, we have provided a comparison with two well-known benchmarks, the Dow Jones Sustainability World index (DJ Sustainability World) and MSCI ACWI ESG Leaders index (MSCI ESG Leaders) . The DJ Sustainability World index is one of the longest running sustainable benchmarks. It represents the top 10% of companies globally, based on one set of long term ESG criteria. As a result, it excludes the vast majority of the investible market. The MSCI ESG Leaders targets companies that have the highest ESG scores in each sector of the MSCI ACWI. It target a 50% sector representation vs. MSCI ACWI so captures a larger number of companies than the DJ Sustainability World. Because these are different constructs from different providers, they have noticeable differences.
However, there are also some commonalities in how they compare with the Shariah portfolios. These are highlighted below.

1. Regional and sectoral differences

Country allocations can vary considerably depending on how Shariah and sustainability considerations are applied (Figure 5). For example, the DJ Islamic World is overweight the US compared with the MSCI ACWI whereas the MSCI ACWI Islamic is underweight this market. Individual active fund allocations to the US vary from as low as 17% to as high as 61%. There is also a significant difference between the two sustainability benchmarks. Large differences also exist across many other country allocations. While this lack of consistency can be confusing, it underlines that there is no definitive view of either Shariah or sustainable investing.

Figure 5: There is no definitive view of Shariah or sustainable investing

	MSCI ACWI	DJ Islamic World	MSCI ACWI Islamic	Islamic Fund 1	Islamic Fund 2	Islamic Fund 3	Islamic Fund 4	DJ Sustainability World	MSCI ACWI ESG Leaders
Market size ($ trillion)	46.8	25.3	13.5					10.2	23.6
DM/EM split (%)									
DM	88	90	87	n/a	n/a	n/a	n/a	94	88
EM	12	10	13	n/a	n/a	n/a	n/a	6	12
Largest 10 countries (%)									
US	55	62	44	35	61	59	17	41	55
Japan	7	6	8	6	14	3	13	5	7
UK	5	4	6	8	1	8	9	8	4
China	4	4	4	1	0	3	8	0	3
France	3	2	5	7	1	3	8	8	3
Canada	3	2	3	2	1	0	3	2	3
Switzerland	3	4	7	12	3	0	5	10	2
Germany	3	2	5	3	2	4	12	6	3
Australia	2	2	2	3	2	2	0	3	3
Korea	1	2	3	2	0	3	6	1	1
Other	13	11	13	20	15	15	20	17	15

Based on data as at 30 June 2019. Source: Dow Jones, Morningstar, MSCI, Schroders.

More consistent differences between the approaches emerge at the industry level (Figure 6, on the next page). As previously explained, the almost complete exclusion of the traditional financial sector from Islamic benchmarks is the biggest difference. Leverage constraints also mean that utilities are excluded from many Shariah portfolios. A combination of leverage restrictions and the exclusion of the hotel sector rule out many real estate companies. These differences exist versus both the broad market and also sustainable portfolios. The healthcare sector is the only one that is consistently overweight relative to the broad market in all Shariah portfolios in our analysis. The DJ Sustainability World is also overweight this sector.

Thereafter, the various portfolios diverge considerably. Some benchmarks and portfolios are overweight the information technology sector but others are underweight (relative to both the broad market and sustainable portfolios). One reason for this is the differing methodologies for accounting tests of leverage and cash, described earlier. Another notable area of difference is in the allocations to the energy and materials sectors. The DJ Islamic World has a 12% allocation to the combination of these sectors, close to the MSCI ACWI. However, the MSCI ACWI Islamic has an allocation of 28%. The range of allocations among active funds is even wider. In contrast, sustainable benchmarks have a slight underweight to these sectors, recognising their environmental impact. This distinction is important. The mainstream Shariah investment universe does not currently prioritise environmental considerations, even though the Islamic goal for society entails preservation of resources bestowed by Allah (swt) for every generation.

2. Diverse portfolios result in diversity of financial metrics

In terms of standard financial metrics, there is no strong evidence that Shariah compliant funds score better or worse than standard approaches. This results from the significant diversity among portfolios. The DJ index's overweight to the profitable, relatively asset-light, technology sector and the MSCI index's overweight to the less profitable, more asset-intensive, energy and materials sectors are particularly important in this context. For example, the DJ Islamic World has a higher return on equity, return on assets and return on invested capital than the MSCI ACWI but the MSCI ACWI Islamic is below the MSCI ACWI for return on equity and return on invested capital (Figure 7, on the next page). The degree of variability is even greater at the individual fund level.

In contrast, the sustainable indices we have analysed have a bias towards stronger financial metrics than the broad market. The MSCI ACWI ESG Leaders index scores more highly than MSCI ACWI on all three metrics, while the DJ Sustainability World scores more highly on two (at a similar level to the MSCI ACWI ESG Leaders) and is comparable on one.

Two additional points are worth noting. First, differences in how sustainable portfolios are put together means that these results do not always hold at the individual fund level. Second, the DJ Islamic World scores more highly than both sustainable indices considered in this analysis. However, as this arises from this index's overweight to the technology sector, rather than as a direct consequence of Shariah beliefs, caution should be exercised when putting any emphasis on this final result.

Figure 6: Industry sector allocations vary considerably, %

	MSCI ACWI	DJ Islamic World	MSCI ACWI Islamic	Islamic Fund 1	Islamic Fund 2	Islamic Fund 3	Islamic Fund 4	DJ Sustainability World	MSCI ACWI ESG Leaders
Financials	17	1	0	0	0	0	0	18	16
Information technology	16	27	15	13	36	23	7	22	19
Healthcare	11	18	19	25	16	18	24	18	11
Consumer disc	11	11	11	10	12	8	5	6	11
Industrials	11	12	10	13	15	0	10	11	10
Communication services	9	8	2	1	0	20	6	2	10
Consumer staples	8	9	10	18	8	6	7	11	8
Energy	6	5	17	12	3	7	24	4	5
Materials	5	7	11	5	2	7	11	4	5
Utilities	3	1	3	0	3	0	4	3	3
Real estate	3	1	2	1	0	0	0	2	3
Other (cash and bonds)	0	0	0	3	4	10	3	0	16

Based on data as at 30 June 2019. Source: Dow Jones, MSCI, Schroders.

Figure 7: A lack of consistency in financial metrics

	MSCI ACWI	DJ Islamic World	MSCI ACWI Islamic	DJ Sustainability World	MSCI ACWI ESG Leaders
Return on equity %	21.4	26.7	17.0	23.4	24.7
Return on assets %	7.6	10.8	7.9	7.6	8.8
Return on invested capital %	13.2	15.0	12.0	14.7	14.9

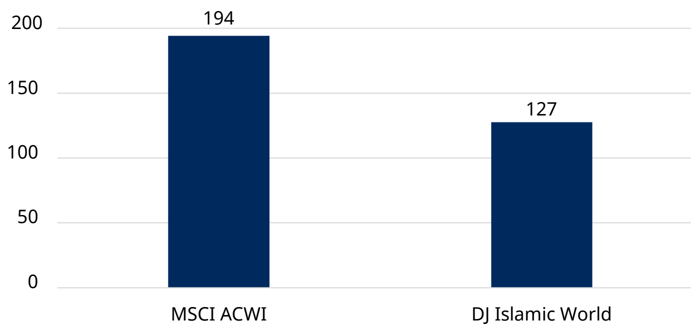
Data covers 12 months to 31 August 2019. Similar conclusions can be drawn when data is assessed over the past five years.
Figures shown are weighted medians. Source: Morningstar, Schroders.

3. Shariah portfolios score better on sustainability criteria than the broad market

Our research shows that the DJ Islamic World scores much better than the broad market on a number of sustainability criteria. Despite it not being a focus, the carbon intensity of the DJ Islamic World, measured in tonnes of CO2 emissions per million dollars of revenues, is 34% lower than the MSCI ACWI, a significant reduction (Figure 8). One reason for this is that the DJ Islamic World has minimal exposure to the utilities sector, avoiding heavy-polluting coal-fired power plants in particular. This underweighting relative to the broader market occurs, not for environmental reasons, but because these companies tend to have high levels of leverage, which breach the Dow Jones Shariah criteria.

Figure 8: Shariah portfolios have lower carbon intensity than traditional portfolios

Carbon intensity (Tonnes of CO2 emissions / $1 million revenues)



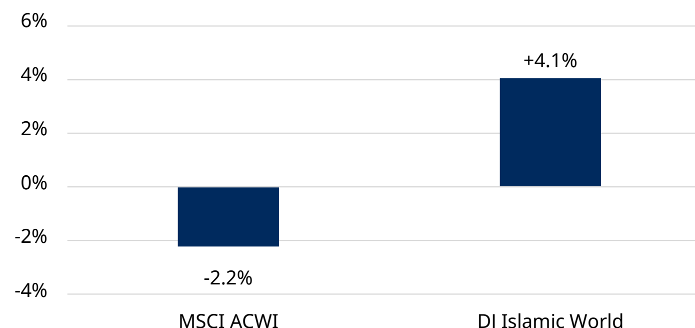
Source: Schroders. Based on data as at 30 June 2019.

It is also possible to make a broader assessment of the social impact of companies in Shariah portfolios compared with traditional portfolios. Schroders' proprietary SustainEx model allows us to do this. It quantifies the external costs and benefits imposed by a company on society across a wide ranging set of variables[16]. Historically society, the environment and governments have picked up the tab but, from carbon credits to sugar taxes, this is changing. SustainEx assesses the impact on a company's profitability if these costs and benefits were pushed back on to the companies which generate them. The analysis can be aggregated into a single figure, which scales a company's net social cost to its revenues. For example, the social value/sales for the MSCI ACWI is -2.2%. In other words, for every $100 of sales, there is an additional $2.20 of costs imposed on society and profits would be $2.20 lower if these costs were fully recognised. Given that the net profit margin on the MSCI ACWI is currently 8.7% (source: Bloomberg, July 2019), an imposition of an additional cost of $2.20 would reduce that profit margin to 6.5%, a 25% reduction. This should not be interpreted as an expectation, rather as an indicator of the risk facing companies.

16 Examples include environmental metrics such as CO2 emissions and water usage. It captures the costs associated with treating and managing problems associated with alcohol, gambling and tobacco. It also compares the effective tax rates paid by companies with the statutory tax rates for the regions where they operate, as a measure of their over- or under-payment, and the value they contribute or detract from society. It additionally recognises the benefits that accrue to society from different activities. These include charitable donations and the social value of employment (compensation levels, employee training etc.). For more information, please see SustainEx, Schroders, April 2019.

Figure 9: Shariah portfolios have a positive social impact whereas standard portfolios have a negative impact

Social value/sales



Source: Schroders. Based on data as at 30 June 2019. Social value/sales is an estimate of the external costs and benefits imposed by a company on society across a wide ranging set of variables. A positive figure represents unrecognized positive impacts, a negative figure unrecognised costs. Examples include environmental metrics such as CO2 emissions and water usage.
It captures the costs associated with treating and managing problems associated with alcohol, gambling and tobacco. It also compares the effective tax rates paid by companies with the statutory tax rates for the regions where they operate, as a measure of their over- or under-payment, and the value they contribute or detract from society. It additionally recognises the benefits that accrue to society from different activities. These include charitable donations and the social value of employment (compensation levels, employee training etc.). For more information, please see SustainEx, Schroders, April 2019.

The companies in the DJ Islamic World index have, in aggregate, a materially better social impact than the MSCI ACWI. Rather than imposing an unrecognised cost on society, companies in this index have a net positive social value, on aggregate. SustainEx analysis estimates their social value/sales at +4.1% (Figure 9).

There are elements of Shariah investing's more favourable scoring for social impact which are very purposeful; for example, the exclusion of alcohol, gambling and tobacco companies, which are clearly very harmful for society. However there are other elements which are accidental, such as the low exposure to utilities noted above. If utilities were to reduce their debt levels, then they could form part of Shariah portfolios and this advantage would disappear. The MSCI ACWI Islamic is a case in point – it has the same weight in the utilities sector as the MSCI ACWI and is overweight the energy and materials sectors.

The DJ Islamic World also scores well for having a large allocation to the healthcare sector, given the potential benefits to society from medical advances. However, this is a fortuitous side effect of other sectors being excluded rather than because the index has been designed to favour healthcare companies in any way.

Formal integration of sustainability within a Shariah portfolio would make these improvements more purposeful and resilient. It would also formally recognise that sustainability principles are at the core of Islamic beliefs, a fact which has failed to receive the prominence it deserves among traditional Shariah investment strategies. It would furthermore be a progression from the current practice of excluding what is wrong, to also prioritising what is right – to a more integrated form of Shariah investing.

Shariah investing does not damage return potential

Understanding the aggregate performance of Shariah portfolios and the impact of the restrictions fund managers and index providers have applied is problematic as the most commonly used indices vary so much in their construction rules. In addition, a Shariah universe does not have to be entirely rules-based and can be subject to interpretation by scholars. (This is also a problem of measuring the impact of a sustainability filter on a standard universe). To overcome this we have analysed the risk and return characteristics of a customised universe provided by Maybank Asset Management ("MAM").

MAM uses the methodology of each of the four major indices (Dow Jones Islamic, MSCI Islamic, FTSE Shariah and Russell-IdealRatings) to create an expanded universe of Shariah-compliant stocks (covering both developed and emerging markets). Stocks that pass the test for inclusion in any one of these four indices (the criteria are summarised in Appendix 1) can be considered as Shariah investments, which would then be submitted to a Shariah adviser for approval. What we understand is that while the indices have prescriptive rules, a Shariah adviser can work with a much broader set of principles,potentially opening up the universe of Shariah-compliant investments considerably.

To make the back-test more manageable, we have then narrowed the universe constructed on these principles to approximately 95% of the total market cap of the universe as at 30 June 2019, totaling around 4,500 securities.

The resulting portfolio is rebalanced monthly and is market-cap weighted. We have run this analysis since December 1999 and also since May 2007, the inception date of the MSCI ACWI Islamic index. The results of the analysis are shown under the heading "Expanded Shariah universe" in Figure 10 below.

Since May 2007, this expanded universe delivered returns that were broadly in line with the DJ Islamic World, outperforming both the MSCI ACWI and MSCI ACWI Islamic. Longer term performance is even better. The main reason for recent outperformance relative to the MSCI ACWI is in the stocks included at the individual country level. For example, the US component of the portfolio has outperformed the broader US equity market. Negligible exposure to the financial sector has been a benefit. In contrast, country allocations detracted from recent performance – in particular an overweight China allocation and underweight US allocation compared with the MSCI ACWI hurt performance (although this China overweight benefited performance in earlier years).

In terms of risk, the volatility of the expanded universe has been comparable to the MSCI ACWI. As a result it has delivered a higher Sharpe ratio than a non-Shariah benchmark over both time horizons. It has also outperformed the DJ Islamic World over the long run, and roughly matched it since May 2007 on this basis. It has additionally generated a higher Sharpe ratio than the MSCI ACWI Islamic since its inception.

Shariah investing has produced better returns and risk-adjusted returns than a standard global equity universe. There is no tradeoff between Shariah principles and maximising return.

Figure 10 – Return and risk of Shariah compliant global indices

	MSCI ACWI	DJ Islamic World	MSCI ACWI Islamic	Expanded Shariah universe[17]
Since December 1999				
Return	4.7	4.1	n/a	6.8
Volatility	15.4	15.7	n/a	15.5
Sharpe ratio	0.15	0.11	n/a	0.29
Since May 2007				
Return	5.0	6.2	4.8	6.2
Volatility	16.3	15.6	15.8	16.4
Sharpe ratio	0.21	0.30	0.21	0.29

Past performance is not a guide to the future and may not be repeated.

Source: Bloomberg, Maybank Asset Management, Refinitiv, Schroders. Annualised returns shown in US dollars.

17 This index captures the performance of a global universe of Shariah-compliant stocks, based on a methodology designed by Maybank. With approximately 4,500 constituents, the index covers 95% of the market capitalisation in the total universe of 20,000 securities, based on data as at 30 June 2019. The index is rebalanced monthly and is market-cap weighted.

Sustainable investing can enhance performance

There is a large body of academic research supporting the view that there is a positive relationship between companies with strong ESG criteria and corporate financial performance. The most exhaustive academic study in this area, which combined the findings of around 2,200 individual studies, found that the large majority of studies demonstrated a positive relationship between ESG criteria and corporate financial performance[18]. Roughly 90% of studies found a non-negative relationship.

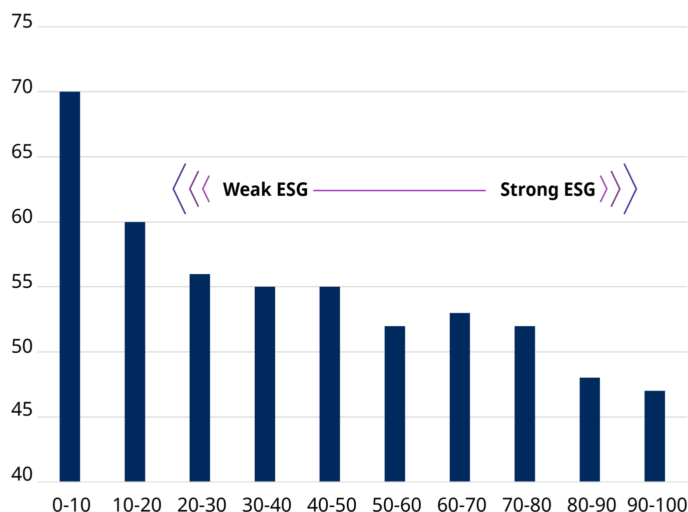
Some explanations are intuitive. A stronger corporate culture and focus on the long term can improve the adaptability and durability of a business model. Superior relationships with stakeholders, such as suppliers, have also been shown to result in fewer disruptions[19]. Avoiding companies with poor ESG credentials can also reduce the risk of being exposed to controversies. Companies with stronger ESG scores tend to have lower drawdowns (peak to trough declines) than those with poor scores (Figure 11).

18 Gunnar Friede, Timo Busch & Alexander Bassen (2015) ESG and financial performance: aggregated evidence from more than 2000 empirical studies, Journal of Sustainable Finance & Investment, 5:4, 210-233, DOI: 10.1080/20430795.2015.1118917

19 Lee and Faff (2009), who show that firms with superior sustainability scores have a substantially lower idiosyncratic risk. Similar findings are provided by Oikonomou, Brooks, and Pavelin (2012). The insurance value of CSR against risks has also been stressed by Godfrey (2005), Godfrey, Merrill, and Hansen (2009), and Koh, Qian, and Wang.

Figure 11: Stronger ESG leads to lower drawdown risk

Maximum five-year drawdown, 2005-2015



Past performance is not a guide to the future and may not be repeated.

* Based on average of Environmental, Social and Governance scores applied to the universe of ESG-ranked stocks in the BofAML US coverage universe. Source: Schroders, Thomson Reuters, BofA Merrill Lynch Global Research.

Conclusion

Sustainable investing is growing in popularity. The Schroders Global Investor Study found that many investors in Asia and in the Muslim world are putting an increased emphasis on this in how they allocate their investments and are concerned about the impact that climate change will have on their portfolios. There is an opportunity for the Shariah investment industry to capitalise on this.

The teachings of Islam are firmly aligned with the principles of sustainable investing. This needs to be formally recognised in product offerings and this aspect needs to be promoted more actively to potential investors. Incorporation of sustainability considerations is both complementary in philosophy to Shariah investing and has the potential to improve investment outcomes. The Shariah industry has languished but, if it bridges this divide, it has the potential to grow substantially and better serve the Muslim community.

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Appendix 1: Typical Shariah exclusions

Sustainable investing often takes an integrated, as opposed to exclusionary approach. In addition, there are many differing views about what constitutes a sustainable or responsible company or sector. However, certain sectors tend to score more poorly on sustainability criteria and are consistently underweighted in sustainable portfolios. These have been highlighted below.

Common exclusions/ non-preferred sectors	Shariah-compliant investing	Sustainable investing
Adult entertainment	•	•
Alcohol	•	•
Gambling	•	•
Tobacco	•	•
Weapons/arms/defence good manufacturing	•	•
Hotels	•	
Food production packaging and processing	•	
Movies	•	
Music	•	
Non-Islamic banking	•	
Non-Islamic finance	•	
Non-Islamic insurance	•	
Pork-related products	•	†
Television	•	
Fossil fuels		•
Non-permissible threshold (less than)	5	n/a
Accounting ratio thresholds		
Total debt	33	n/a
Total cash + interest bearing securities	33	n/a
Total receivables	33	n/a
Denominator	2 yr average market cap or asset value	n/a

† Some responsible investing funds exclude pork and other meat-related products due to the carbon footprint of meat.
Source:S&P Dow Jones, Schroders.

Appendix 2: Screening criteria of four Shariah indices

	FTSE	Russell IdealRatings	DJIM	MSCI
Prohibited Industries and Activities	1. Conventional financial services 2. Alcohol 3. Pork-related products and non-halal food production, packaging and processing 4. Entertainment (casinos, gambling and pornography) 5. Tobacco 6. Weapons, arms and defence manufacturing	1. Adult Entertainment 2. Advertising, other than internet based 3. Alcohol 4. Cinema 5. Conventional banking 6. Defence 7. Gambling 8. Adult games 9. Gold & silver hedging 10. Insurance 11. Mortgage & lease 12. Music 13. Meat not-slaughtered in Monotheistic country 14. Other financial services 15. Other financials (Middle East) 16. Pork 17. Tobacco 18. Country - Israel	1. Alcohol 2. Pork-related products 3. Conventional financial services 4. Entertainment 5. Tobacco 6. Weapon & defence	1. Alcohol 2. Tobacco 3. Pork 4. Conventional financial services 5. Defence/weapons 6. Gambling/casino 7. Music producers and distributors of music 8. Hotels, owners and operators 9. Cinema 10. Adult Enterainment
Debt / Total Assets	33%	33%	33%	33%
Cash + Interest bearing deposits / Total Assets	33%	33%	33%	33%
Receivables / Total Assets	50%	n/a	33%	33%
Definition of Total Assets	Book value of assets	12 month trailing market capitalisation	24 month trailing market capitalisation	Book value of assets
Income from Non-compliant activities which would need to be purified	Do not exceed 5% of total revenue	Do not exceed 5% of total revenue	Do not exceed 5% of total revenue	Do not exceed 5% of total revenue

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