

Identifying Shariah-compliant equities – a challenging task

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The demand for Shariah compliant investment products has risen extremely in the last decades. In a recent research conducted by Booz & Company the total volume of Islamic assets in 2008 is estimated to be US\$ 500 billion. Additionally, in 2000 the total number of Islamic funds worldwide has been 102 funds growing annually with a CAGR of 28% and is expected to reach 925 funds in 2009.

Similar to ethical and social responsible investments that have to adhere to specific ethical requirements, Islamic financial instruments have to comply with the religious belief and the Shariah laws governing business interactions and investments conducted by Muslims.

Experienced Shariah scholars deduce from these Shariah sources a number of quantifiable guidelines which have to be adhered to when Shariah compliant investment instruments are structured. Generally, Shariah compliant investments have to avoid investment in non-compliant activities such as riba (conventional interest-based instruments), gharar and maysir (highly uncertain and speculative activities such as derivatives) and non-compliant business activities related to pork or alcoholic product, gambling facilities or pornography for instance.

Companies are analyzed by Shariah-compliant fund screening to identify their involvement in Shariah non-compliant business and financial activities. Business activity screening eliminates companies whose primary business activity does not comply with the Shariah, such as conventional banks, bars and casinos. Financial screens, on the other hand, measure businesses' involvement in Shariah non-compliant financing activities, such as interest earnings and debt financing.

Since it is almost impossible to find companies which are not dealing with conventional banks and either earn or pay interest, the Shariah scholars identified specific threshold levels limiting the extent to which companies can be involved in such practices. Some Shariah service providers employ a financial screen in which the cumulated revenue from non-compliant activities (alcohol, pork, pornography...) for any company considered may not exceed 5% of their gross profit. The use of such a threshold level is a relaxation of the Islamic ban to get involved in non-compliant business activities and practices and is revised through purification.

The real challenge of Shariah screening is to identify for the companies considered the proportion of revenue generated from non-compliant activities. This is not an easy task especially in the case of companies whose core or primary business is compliant but due to the wide range of products and services they are engaged in a proportion of revenue might be generated from activities deemed non-compliant under Shariah. Examples of businesses whose core business is compliant but generate a proportion from non-compliant activities include:

- General Motors which generates a large proportion of its revenue from financial services based on conventional interest.
- McDonald's that sells some products including pork (bacon) and in some European countries sell beer or other alcoholic beverages.
- Wal-Mart which in its product palette offers also pork products.
- Honeywell which generates a proportion of revenue from defense and military.
- Airlines that serve and sell alcoholic beverages and pork.
- Airports that operate Duty Free Shops selling alcoholic beverages and tobacco.

Shariah screening providers face the problem that using automated screening using industry

classification codes such as GICS (General Industry Classification System) or ICB (Industry Classification Benchmark) is either highly moderate or highly conservative. If only companies with core non-compliant activities are to be excluded, companies with a large proportion (more than 5%) of revenue generated from non-compliant activities may be wrongly classified as being compliant. If, on the other hand, all companies belonging to industries that might generate non-compliant revenue are to be excluded the result may be the exclusion of compliant companies and an additional effect is large reduction of the asset universe size. If a hotel chain is operating Shariah-compliantly or a food retailer is not selling pork or alcohol, they would still be considered inappropriate.

A company such as Louis Vuitton Moët Hennessy (LVMH) is categorized under the ICB subsector "clothing and accessories". But if we investigate the business operations and financial figures of LVMH in more depth, we can note that a remarkable share of the revenue generated stems from the sales of wine and spirits. For the first quarter in 2008, the total reported revenue of LVMH has been 4002m Euros of which 16% (640m Euros) comes from wines and spirits. Since most Shariah scholars have agreed on a maximum of 5% for non-compliant revenue, LVMH should be classified as non-compliant. However, automated screening using industry classification codes would result in the classification of LVMH as being Shariah-compliant.

An adequate compliance evaluation, such as the one described for LVMH, can only be obtained through in-depth research. Companies assigned to a clearly non-compliant industry (such as brewing) can be considered directly non-compliant. Companies that are generally compliant but operate in multiple business segments need to be analyzed in detail by looking at their financial statements, company websites and news, as well as materials provided by their investor relations departments.

As the global asset universe is large, screening cannot be handled manually. Interactive screening—combining automated and manual research—needs to be applied to overcome the shortcomings of automation.

Such a combined screening is adopted by IdealRatings, which identifies Shariah-compliant services, scanning a global asset universe covering more than 95% of capital markets in more than 96 nations. Automated and manual analysis and research techniques are combined so that end-users can define their own Shariah guidelines and execute them on the most accurate data relevant for Shariah screening.

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